FEDERAL INCOME TAX SIMPLIFICATION

Charles H. Gustafson
Editor

A Joint Project of The American Law Institute,
the Section of Taxation of the American Bar Association,
and the American Law Institute-American Bar Association
Committee on Continuing Professional Education

ALI ABA

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The extraordinary complexity of the federal income tax system is a source of frustration to taxpayers, tax professionals, and tax administrators. As the system becomes increasingly complex, voluntary compliance becomes more difficult and costly, results become less predictable, and enforcement becomes less uniform. Despite these frustrations, the recent trend has been toward even greater complexity.

This volume arises out of an effort to address the problem of complexity and to develop paths toward meaningful simplification. It includes the deliberations of a group of leading tax practitioners, tax administrators, and tax scholars who met in January 1978 to focus specifically on questions of simplification. It also contains the papers prepared for the Conference, which deal with different aspects of the problem. The Conference Report and the papers together provide an insightful examination into the theoretical possibilities and the practical realities of simplifying the federal income tax structure.

(Continued on inside back cover)

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Charles H. Gustafson
of the Georgetown University Law Center
Editor

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AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION
COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION
4025 CHESTNUT STREET • PHILADELPHIA • PENNSYLVANIA 19104

Library of Congress Catalog Number: 79-51416

Printed in the United States of America

Foreword

The 1978 Conference on Federal Income Tax Simplification, which is the subject of this report, had its genesis in a suggestion to the President of The American Law Institute from Hugh Calkins, of the Cleveland, Ohio, Bar, that the Institute turn its attention to law simplification in the federal area. Discussion of this idea prompted a proposal that it might be explored in one specific subject of federal law, not unknown to simplification efforts, that of federal taxation. As this thought developed, the plan evolved that an invitational conference dealing with federal income tax simplification would be an appropriate starting point. Discussions with the officers and relevant committees of the Section of Taxation of the American Bar Association led to the appointment of special Institute and Tax Section committees to elaborate the plan. Representing the Section were Max E. Meyer, of Chicago, Harvie Branscomb, Jr., of Corpus Christi, Texas, and H. Stuart Dunn, Jr., and John S. Nolan, of the District of Columbia. Speaking on behalf of the Institute, in addition to Mr. Calkins, were Norris Darrell, Mendes Hershman, and Herbert Wechsler, of New York, and I. The two groups met, and out of their deliberations developed the overall design of the conference:

1. A separate planning committee should be in charge of the conference. (The names of the distinguished members of that committee appear on page 1 of this report.)

2. The committee was "[t]o plan and conduct an Initial Conference on Tax Simplification . . . , which will explore the feasibility, gains and losses of and alternatives to income tax simplification, including the following aspects:

—large and small individual and business taxpayers
—multiplicity of taxing jurisdictions
—means to achieve feasible simplification measures in light of our present political processes."

3. A conference of some three days duration was to be planned that would be "attended by a representative and specially invited group of 50 to 80 persons drawn predominantly from the bar, but also from the Congress, Administration, accountants, economists, and others."

4. Papers were to "be prepared by qualified persons . . . to be reviewed by consultants in advance of the conference."

5. A "publication shortly after the conference" should be prepared.

6. There should be "follow-up proceedings if the conference is a success."

7. Finally, the conference was to be sponsored by The American Law Institute, the Section of Taxation of the American Bar Association, and the American Law Institute-American Bar Association Committee on Continuing Professional Education.

Obviously, a conference of such broad purpose and scope required substantial financing. A grant in the amount of $25,000 was generously contributed for the conference by the Ford Foundation; another $25,000 was jointly contributed by the American Bar Association through the Section of Taxation and the American Law Institute-American Bar Association Committee on Continuing Professional Education. With this support, the conference was to become a reality. A group of invitees was selected. (See p. 101.) Their invitations stated the goals of the conference:

> Simplification of the income tax system is one of the most frequently cited goals of tax reform. The degree of complexity in the income tax laws is a factor that encumbers voluntary compliance and increases concern about the equity of the system. The effect of reform proposals on the complexity of the system is sometimes discussed in connection with particular substantive proposals. The purpose of this Conference, however, is to address directly the issue of simplification itself as a goal of tax reform and to consider the effect of simplification on different classes of taxpayers, on tax administration, and upon revenue collection. The Conference will also consider aspects of the political process to identify and measure impediments to simplification.

The conference was held January 4–7, 1978, in Warrenton, Virginia. At the final session a report was adopted. (See p. 83.) This volume is the official record of the conference. It was edited by Professor Charles H. Gustafson, who served as the Consultant to the Steering Committee. His distillation of the proceedings (pp. 3–82) adds a useful and necessary dimension to that record. It is a credit to the foresight of the initial planners of the conference and to the conference steering committee that the blueprint for the conference as originally drawn was completely fulfilled, as this report demonstrates.

This volume is published with the hope that the conference will make a continuing and meaningful contribution to the thinking on the simplification problem, not only in federal income tax laws and regulations, but also in the broader sense originally conceived by Mr. Calkins.

One final note. The follow-up conferences envisioned by the Institute and Tax Section committees are now being held. Such conferences were convened in Cleveland, Boston, Chicago, Philadelphia, and Washington, and others are scheduled. A report on those sessions will be forthcoming at some future time.

Paul A. Wolkin
Executive Director,
The American Law Institute-
American Bar Association Committee
on Continuing Professional Education

Preface

These words do not purport to be the last on federal income tax simplification. It is clear that meaningful steps toward the simplification of the federal income tax structure cannot be achieved without the commitment of resources and energies that in the past have regularly been made in support of other, often conflicting objectives.

The Planning Committee, assisted by the vigorous and generous support of The American Law Institute, the Section of Taxation of the American Bar Association, and the American Law Institute-American Bar Association Committee on Continuing Professional Education determined that the Airlie House Conference would be a beginning in the development of such a commitment. The publication of this volume represents another step. It is hoped that further studies, conferences, and meetings—building on the work product of the Airlie House Conference—will endeavor to identify avenues toward simplification that will attract the broad support necessary for its realization.

CHARLES H. GUSTAFSON

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ALI-ABA Conference on Federal Income Tax Simplification

January 4-7, 1978
Warrenton, Virginia

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Cleveland, OH 44114

Max E. Meyer, Esquire
Lord, Bissell & Brook
115 S. LaSalle Street
Chicago, IL 60603

Stanley S. Surrey
Professor of Law
Harvard University Law School
Cambridge, MA 02138

Ex Officio:
Paul A. Wolkin, Esquire
Executive Director
The American Law Institute-
American Bar Association
Committee on Continuing
Professional Education
4025 Chestnut Street
Philadelphia, PA 19104

CONSULTANT

Charles H. Gustafson
Associate Professor of Law
Georgetown University Law Center
600 New Jersey Avenue, NW
Washington, DC 20001

1

Introduction

Charles H. Gustafson

The Conference on Federal Income Tax Simplification was held on January 4-7, 1978, at Airlie House in Warrenton, Virginia, under the sponsorship of The American Law Institute, the Tax Section of the American Bar Association, and the American Law Institute-American Bar Association Committee on Continuing Professional Education. The Conference was attended by lawyers, accountants, professors, and government officials, each of whom had been invited by the sponsoring organizations because of their interest and involvement in matters of tax policy and tax administration.

This volume fully reflects the work of the Conference. It contains the papers and other materials specially prepared for the conferees, a summary of the discussions that took place during the general sessions of the Conference, and a Summary Report of the conclusions that were reached. This introductory chapter is intended to identify the objectives for which the Conference was organized and to describe the background, planning, structure, and operation of the Conference.

THE RELEVANCE OF INCOME TAX SIMPLIFICATION

Complexity in any aspect of life is seldom a revered quality. Complexity impedes achievement and invites failure. Efforts to simplify any aspect of modern existence are, therefore, easily justifiable. There are, however, particular reasons for simplifying the structure of income taxation that prevail in the United States.

Complexity in the structure and administration of the income tax system imperils its effectiveness in several ways. Reliance upon a high degree of voluntary compliance is strongly affected by complexity. A more complex taxing mechanism increases the difficulty of voluntary compliance among those who endeavor to fully satisfy their obligations

* Charles H. Gustafson is an Associate Professor of Law, Georgetown University Law Center, Washington, D.C. Professor Gustafson served as consultant to the Planning Committee of the Conference and as editor of this volume.

to report and to pay. Increased difficulty for these taxpayers requires the investment of even greater amounts of time and effort in recordkeeping and calculation. Further, it leads to the increased dependence on expert assistance for an understanding of the law, the maintenance of adequate records, and the preparation of tax returns.

Complexity may also be important to those segments of the tax-paying public who might be less thorough in the voluntary fulfillment of their obligations. As the requirements of the law become more complex, the task of discovering those who are not in compliance becomes more difficult.

Voluntary compliance is also strongly affected by the degree to which taxpayers believe that the taxing mechanism is equitable and just. The complexity of the tax structure complicates the difficult tasks of analyzing the effects of the system and measuring its degree of fairness. Moreover, the very existence of complexity may contribute significantly to the feeling that the system serves special, rather than public, interests. Such feelings are likely to diminish the propensity to comply voluntarily.

Simplification, then, contributes to effective tax administration; but simplification cannot be the sole objective of the tax system. It would be relatively easy to establish a very simple taxing system that could be administrable within cost limits that might be deemed appropriate. Such a system, however, would probably fail to achieve the degree of horizontal and vertical equity that is desired; and it would require the forswearance of the use of the tax structure to advance social and economic objectives toward which the structure has increasingly been devoted during recent years. Furthermore, the transactions that effect modern economic life are necessarily complex. Any taxing mechanism that depends upon measuring the consequences of these transactions will, of necessity, bear a substantial degree of complexity.

Virtually everyone seems to support tax simplification. Public statements and writings would lead to the clear conclusion that simplification is favored by politicians, businessmen, professionals, and academics. The impression, however, is deceiving. The same kind of apparent consensus has been discernable from the public record for decades during which the actual trend has been toward complexity, not simplicity. Although there was no need for a conference to determine the general goal, the organizers of the Conference perceived that there was a compelling need to identify the reasons why the process of simplification has been stymied and, perhaps, to begin a long-term process of reversal.

MEASURES OF COMPLEXITY

The widespread acknowledgement of the complexity of the tax system does not necessarily reflect a common perception of the specific nature of the problem. The forms of complexity and their consequences differ for different people and institutions responsible for or affected by the tax structure. A primary objective of the Conference was to identify those different perspectives and to consider ways to simplify from each of them.

The taxpayer, whether an individual or an entity, is directly affected by complexity. The time required to prepare an accurate tax return is increasing. The recordkeeping requirements are increasing. It is increasingly difficult to obtain a clear answer to many questions either from the Internal Revenue Service or from professional tax counselors. The trend is accelerating and is unlikely to abate unless substantial changes are made. Frustration, anger, and cynicism will continue to accompany the present trend.

One way that individual taxpayers are dealing with the frustration is by increasingly turning to professional tax return preparers, as well as to lawyers and accountants. It has been suggested, in effect, that the average individual taxpayer may not, even after investing substantial time and effort, be able to understand and fulfill his obligation to file an accurate tax return. The increasing use of professional help has led some to suggest that simplification objectives should be established not for the taxpayer, but for those professionals who are performing the work. Regardless of whether this conclusion can be accepted, it is useful to consider the ways in which professionals are affected by complexity.

The tax counselor, as well as the tax return preparer, is confronted regularly with questions that cannot clearly and certainly be answered. There are statutory modifications at an increasing rate. In some cases, the statutory prescriptions are vague, ambiguous, or absent. In other instances, sufficiently clear regulations have not been promulgated. There are inconsistencies of judicial interpretation. The professional must, of course, offer a considered judgment based on the ambiguities. But the acceptance of the considered judgment by the taxpayer-client may be strongly mitigated by the hope, or perhaps the expectation, that the Internal Revenue Service will never really raise the issue.

Complexity greatly compounds the tasks of tax administration. More sophisticated laws require more sophisticated responses by taxpayers and by their representatives, which in turn require more sophisticated techniques on the part of the Internal Revenue Service. More highly

skilled officers must be hired. More specialized training must be provided. The costs of administration are increased accordingly, and the probability of an uneven enforcement of the tax laws is enlarged. It is unlikely that any Commissioner has shared in the disdainful amusement created each spring when newspaper accounts report the disparate advice given by Internal Revenue Service offices in different parts of the country. Absolute uniformity of administration can, of course, never be achieved in a system in which discretion must be exercised in the field, but complexity increases the likelihood of unacceptable degrees of inconsistency.

A final perspective on complexity may be that of the Congress. During the past few years, attention has been devoted to the problems of complexity. There have been hearings. A study was commissioned. But Congressional concern has produced no meaningful direction toward simplification. It is possible that the political process of lawmaking itself breeds complexity; and no proposal considered alone will seem to create an unacceptable degree of complexity.

These perspectives have similarities and differences. The Conference was organized to include individual discussions of each.

SOURCES OF COMPLEXITY

There are many sources of complexity in the income tax laws. Some are obvious; others are more difficult to discern.

Many of the most fundamental premises of the Code create a degree of complexity that cannot be avoided without abandoning or modifying the premises. If all income "from whatever source derived" is truly to be subject to potential taxation, issues of timing and measurement must be addressed. If each individual, estate, and trust, and most corporations are to be separate income taxpayers, problems of identification and attribution cannot be avoided. If each taxable year is to be considered separately within a progressive rate structure, timing and attribution problems are enlarged. If expenditures relating to income production are to be deducted, there are additional elements of necessary complexity.

Each of these premises leads to unavoidable degrees of complexity, which, in turn, are magnified by the nature of the modern economy. The complexity of modern transactions necessarily complicates the task of determination, timing, and attribution of income and deductions. Some transactional complexity, moreover, derives from the tax law

itself. In any event, evolution of new kinds of trade, investment, and financing devices among different entities with different interests must be expected to continue with its attendant unavoidable complexities.

A further contributor to unavoidable complexity is the federal system. A taxpayer is likely to be subject to multiple income-taxing jurisdictions. The income tax laws of states and cities, particularly because of their lack of uniformity with the federal law and with each other, add substantially to the burdens of complexity.

Other sources of complexity are directly attributable to choices that have been made about the most major premises of our tax structure. The tax structure has been used to aid in the achievement of a vast array of social and economic objectives. Deductions and credits have been established to encourage taxpayers to make certain kinds of business and personal expenditures and to aid those beset with unusual burdens. Income earned by some organizations has been exempted from taxation because of the efforts upon which those organizations are embarked.

The trend has been strong and clear. Lawmakers have found it difficult to resist the temptation to use the tax laws for such purposes. The attractiveness is obvious. Most federal programs require a long time to organize and implement; but, for example, an investment credit, perhaps made retroactively applicable, as in the 1971 legislation, is expected to stimulate investment instantly. Moreover, in theory at least, tax expenditures can be terminated without the resistance of an ensconced bureaucracy eager to preserve its own life.

Each new tax expenditure, of course, breeds complexity for at least some of the persons affected by the system. New definitions must generally accompany the new tax expenditure program. Taxpayers, lawyers, accountants, and tax return preparers must be able to understand and to apply the new provisions. There is often a period of definitional ambiguity during which the process is further complicated. New transactions are conceived and implemented to exploit the new benefits, as was presumably intended. In some cases, the viability of an entire industry depends upon the existence and operational contours of a tax expenditure program.

The trend itself breeds further complexity. It is very difficult to argue for the rejection of one more tax expenditure program on the ground of simplicity when that single program is to be added to an already tangled structure. The same phenomenon, moreover, is likely to deter enthusiasm for proposals to restrict the amount of complexity in the tax laws in relatively modest ways.

Those who oppose tax expenditures also tend to encourage complexity. The history of the Internal Revenue Code is marked by a recurring cycle. Provisions that create a tax expenditure are enacted. Transactions are evolved to exploit the provisions. The political process leads to the eventual modification, but seldom the elimination, of the tax expenditure. The process results in substantially more complexity. The maximum and minimum taxes enacted by the 1969 Act are frequently cited as examples of this process.

Even the enactment of simplifying provisions has resulted in eventual complexity. Arguably, the preferential treatment of long-term capital gains, in addition to the encouragement of certain forms of capital formation, constitutes a rough response to the problems of inflation and averaging. A capital gain measured in dollars may not accurately reflect increases in real value; any increase, though wholly recognized in the year of sale, may in fact have occurred over several taxable years. The capital gains deduction may reflect both potential inequities, although it is not precisely determined or measured by either.

This simple solution, however, breeds much complexity. Transactions are created to convert ordinary income into capital gains. The practices of corporate managers are necessarily affected by the disparate treatment of dividend income and stock profits to shareholders. Special rules are evolved to define the income that is to receive the special benefit; then new rules are developed to treat transactions effected to exploit the first. Eventually, such devices as the maximum and minimum taxes are evolved as a rough correction of the rough simplicity. But the result is very complex.

THE MOVEMENT TOWARD SIMPLIFICATION

Concern about tax simplification is, of course, not new. In 1926, Congress charged the Joint Committee with the responsibility of simplifying the tax laws. The 1954 Code was described as an act of simplification. Political leaders of virtually every stripe have condemned the cumbersome tax structure with varying degrees of colorful invective.

Professional groups have seriously considered the matter. In 1972, the Committee on Tax Policy of the Tax Section of the New York State Bar published a thoughtful study that reflected the views of their working group. This study recommended, among other actions, that a constituency for simplification be established through a Blue Ribbon Commission vested with the responsibility to urge simplification objectives among those that otherwise compete for legislative and regulatory atten-

tion. The American Institute of Certified Public Accountants and the American Bar Association have also organized working committees that have examined problems of simplification.

Despite the attention, advances for simplification have been modest. The Tax Reform Act of 1976, reiterating the charge of 1926, directed the Staff of the Joint Committee on Taxation to prepare a study on simplification issues. That study, which was published in September 1977, constitutes a very useful introduction to the issues addressed at the Conference. The 1976 directive to study simplification was accompanied by a few substantive measures toward that end and by many other measures that were complex. The Tax Reduction and Simplification Act of 1977 introduced the zero bracket arrangement, which reduced the number of itemizing taxpayers and introduced some other provisions that had a simplifying effect. But the list of exceptions to the overall trend toward complexity is very short.

ORGANIZATION OF THE CONFERENCE

The members of the Planning Committee [1] were practitioners and professors who have been deeply involved with the substance and administration of the tax system. Its membership, moreover, represented many years of governmental experience in the formulation and implementation of tax policy.

The Conference was conceived as an attempt to begin a process that might produce simplification. The Planning Committee hoped that the Conference would bring together practitioners, academics, and government officials to focus carefully on the problems of complexity, to identify its various causes, and to consider measures for reducing it. It was further anticipated that other meetings would be held in various parts of the country at which the interest and analysis of this first Conference could be refined and extended so that over time a broader constituency for, and interest in, simplification might evolve.

The Planning Committee commissioned Conference Papers dealing with various aspects of the simplification. The Conference Papers, each of which is reproduced in Appendix Two of this Report, were circulated to the participants prior to the Conference so that the time of the Conference could be devoted to further exchanges, rather than merely to the reading of the various papers.

The Conference began with a general welcoming address by the Chairman of the Planning Committee, Erwin N. Griswold. During the

1 The members of the Planning Committee are listed on p. 1.

following two days, the Conference met in six general sessions. Those general sessions were devoted to the following topics:

(1) Basic considerations in tax simplification—an overview

(2) Simplification for individual taxpayers

(3) Problems of managing the complexity of the system

(4) Simplification for business taxpayers

(5) Effects on simplification of the relationship between the federal and state and local income tax systems

(6) The political process of achieving simplification.

These topics were selected from the wide number of matters that could appropriately be discussed at this kind of meeting. The Planning Committee selected the topics so that they would include a representative array of issues that could reasonably be considered in the limited available time. The Committee fully recognized that many other topics might have been selected. In fact, entire conferences could justifiably be devoted to the complexities of various portions of the Code. It was contemplated that the subsequent regional meetings might well consider some of the topics that were omitted from this Conference.

On the evening following the sixth general session, the Conference participants were divided into six working groups. Each group focused more specifically on particular topics that had previously been discussed in the general sessions. Each working group was to prepare a report of observations, concerns, and recommendations with respect to its particular topic for consideration by the Conference as a whole.

On the final day of the Conference, the six working group reports were presented and discussed in a general session. No formal votes were elicited, however, with respect to any of the recommendations.

USE OF THIS REPORT

This volume consolidates the learning of the Conference for further use in developing steps toward simplification. The next portion consists mainly of a summary of the discussions that were held at the general sessions. Each summary should be read in conjunction with the Conference Papers that were prepared for the particular session and which are reproduced in Appendix Two. These summaries were prepared from the transcripts that were made of the sessions. The summaries identify only the speakers who served as moderators, panelists, or commentators. Speakers from the floor are not generally identified. The transcript

itself has been reproduced in one instance. Since no Conference Papers were prepared for the third general session, Problems of Managing the Complexity of the System, the transcript of the session has been reproduced to preserve the full statements of the panelists.

Finally, the Summary Report of the Conference, prepared by Professor Michael J. Graetz, based on the final general session, is set forth. This Summary Report reflects fully the results of the individual working group reports and the comments offered during the course of the final general session in which the reports were presented and discussed.

The Planning Committee envisaged this Conference as part of a process that might lead to simplification of the tax laws. This volume has been prepared in the hope that it may further contribute to that process. The consensus of the Conference participants was that "simplification isn't a simple matter." Although a reader of the materials in this volume will undoubtedly agree with such a conclusion, one might also discern reasons for hope that progress toward simplification is possible if sufficient energy and intellect are devoted to its attainment.

2

Basic Considerations in Tax Simplification—An Overview

Session: Thursday Morning, January 5, 1978

Moderator: Stanley S. Surrey

Panelists: Gerard M. Brannon
Harvey Galper
Sidney I. Roberts
Deborah H. Schenk

The general purpose of this initial session was to lay a foundation for the remainder of the Conference discussions. The specific objectives were to survey the array of possible definitions of tax simplification, to identify those individuals and organizations concerned with issues of simplification, and to explore the concept of simplification from various relevant perspectives.

Professor Deborah H. Schenk discussed simplification for the average taxpayer.[1] She strongly urged that simplification be considered from the perspective of the professional tax return preparers, rather than that of an average taxpayer. Professor Schenk suggested that it would be unrealistic to establish as a goal that the average taxpayer be capable of preparing his own return. She stated that the majority of Americans cannot or will not prepare their own tax returns. Therefore, the most helpful result for a conference such as this would be the establishment of a reasonable standard that income tax return preparers might be trained to meet.

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* Stanley S. Surrey is a Professor of Law at Harvard University Law School, Cambridge, Massachusetts.

Gerard M. Brannon is a Professor of Economics in the Department of Economics at Georgetown University, Washington, D.C.

Harvey Galper is Associate Director of the Office of Tax Analysis of the United States Treasury Department.

Sidney I. Roberts is a member of Roberts & Holland, New York, New York.

Deborah H. Schenk is an Associate Professor of Law at Brooklyn Law School, Brooklyn, New York.

[1] Professor Schenk's Conference Paper is reproduced in Appendix II, pp. 115–35.

Sidney I. Roberts suggested that the focus of attention be directed at the tax lawyer.[2] He observed that complexity is substantially increased because of the many areas of ambiguity in the income tax laws in which neither attorneys nor tax administrators know what the law exactly provides. This basic ambiguity fosters reliance on the tax lottery and has an adverse impact on expectations of voluntary compliance.

Mr. Roberts supported a conclusion of a subcommittee of the New York State Bar Association that considered the question of simplification a few years ago. He recommended that a commission be established, which would consist of prominent members provided with adequate funding and manpower, devoted to the development of reasonable steps in the direction of simplification. Such a commission might develop a degree of prestige that would allow concerns for simplification to be heard by Congress, along with those of other interests engaged in lobbying efforts.

Harvey Galper discussed the relationship between comprehensive income taxation and the simplification of the tax laws.[3] Mr. Galper discussed the comprehensive income tax proposal set forth in the Treasury Department volume *Blueprints for Tax Reform* (1977). *Blueprints* proposed a simplified structure of rates and exemptions, accompanied by a greatly expanded tax base achieved primarily by eliminating exemptions, deductions, and credits. Virtually all sources of income would be taxable. Preferential treatment for capital gains would be eliminated. There would be a complete integration of personal and corporate income taxes. An inflation adjustment would apply for certain assets in determining gain or loss and in calculating depreciation. Mr. Galper observed that this kind of system might reduce "dynamic complexity," the process by which the tax law has been made increasingly complex by a series of provisions and amendments. He also noted that the introduction of such a system would itself be complex. The evolution of substantially lower rates, however, would reduce the pressure for complex transactions to avoid the very high marginal tax rates that now exist. It would also provide an opportunity for eliminating special provisions, such as the minimum tax and the maximum tax, which were designed to mitigate against some of the consequences of the existing structure. Most personal deductions would be eliminated.

The final speaker was Professor Gerard M. Brannon, who discussed the relationship between simplification objectives and other tax objec-

[2] Mr. Roberts' Conference Paper is reproduced in Appendix II, pp. 137–59.

[3] The Conference Paper prepared by Mr. Galper and Mr. Kaufman is reproduced in Appendix II, pp. 161–90.

tives.[4] Professor Brannon discussed the conflicts and trade-offs between simplification objectives and considerations of equity and efficiency at the technical level. He also discussed the political consequences of simplification. He underscored the extreme difficulty of calculating the costs of complexity and comparing them with considerations of equity and efficiency. He also observed, however, that there were some easy steps toward simplification that might be taken. One step would be the elimination of the deduction for state sales taxes, accompanied by a periodic distribution from the Treasury to state collection officials. Another would be the repeal of limitations surrounding the investment credit. Any revenue loss could be accompanied by a reduction in the rate of the credit. Although some proposals for simplification are obvious and relatively easy to implement, they have not been enacted. Professor Brannon concluded that the difficulty in enacting easy simplification measures is cause for pessimism about the enactment of the more difficult ones. Finally, he noted that simplification almost always results in a reallocation of tax burdens among the taxpayers. Accordingly, proposals *purely* for simplification are hard to find.

Following the general remarks of the panelists, based on their respective papers, they directed questions at one another and offered further comments on the various presentations.

Professor Brannon observed that the attractiveness of the tax lottery would be diminished if the risks of punishment were increased, either by more rigorous enforcement or by the imposition of greater penalties. Mr. Roberts responded that the imposition of higher penalties is more difficult because of the ambiguity and complexity of the tax law. The result is an invitation to arbitrary and inconsistent enforcement. In that situation higher penalties are less acceptable. Professor Schenk suggested that the tax lottery is particularly unfair because there are groups of taxpayers who do not have the experience or sophistication to know of its existence or who do not know how to use it.

The panelists discussed ways of measuring the degree of noncompliance that presently prevails. Mr. Roberts contended that although collections appear to be increasing with rising income levels, an analysis of that portion of taxes collected outside of wage withholding would give a somewhat different picture.

Dean Griswold observed that the litigation process, involving many different forums, invites further ambiguity and resulting complexity in the taxing mechanism. He noted further that there are a number of problems of a recurring nature that may be very difficult in terms of

[4] Professor Brannon's Conference Paper is reproduced in Appendix II, pp. 191–204.

factual distinctions, but that invite the establishment of clear lines. He referred to the Clifford Trust regulations as an example of a means to achieve a degree of predictability in a complex legal area.

Comments and questions were then offered from the floor. One participant suggested that true simplification would depend on the elimination of the incentives in the present structure that lead taxpayers to engage in complex behavior, which, in turn, leads to complex legislation, administration, court cases, rulings, and compliance problems addressed to this taxpayer behavior. He cited the rate schedule, taxpayer definition, and the annual accounting period as three such incentives. He suggested that the establishment of a flat rate would substantially eliminate incentives for the development of many complex transactions. Without suggesting any particular approach, he urged that the elimination of the incentives be addressed. Mr. Galper noted that *Blueprints* would apply a single tax rate of 25 per cent to a broad spectrum of taxpayers; in addition, there would be modest degrees of progressivity within very broad ranges.

One participant questioned whether a conference on tax simplification was necessarily justifiable in light of the degree of complexity that exists in other aspects of modern legal life. Further, he inquired whether experience in other aspects of life might provide assistance in dealing with questions of tax simplification. Mr. Roberts pointed out that the tax system affects almost everyone within the society and, therefore, constituted a highly appropriate subject for consideration.

Another response was that concern for tax complexity was justified not only because of its pervasive nature but also because of the increasing tendency to use the taxing mechanism as a device for implementing governmental programs. The speaker suggested that the Conference should address the system by which the extraordinarily complex and sometimes inconsistent provisions of the tax law have been created. Another conferee suggested that it is appropriate to focus on the tax system, compared with other areas of law, because the technology of the tax law changes more rapidly than other areas of law, such as real estate.

The idea of a Blue Ribbon Commission was criticized on the grounds that its impact would probably have little effect on highly publicized and controversial tax issues. It would be effective primarily in low intensive, low controversy issues affecting a relatively small number of unorganized taxpayers who were not highly represented in Congress. In response, Mr. Roberts indicated that the Commission would serve two very important purposes: It would serve as an alternative to the existing

situation in which no one acts on the behalf of the system; and it would focus attention on the importance of simplification. The importance of these considerations will be increasingly apparent if the cumbersome taxing structure is further strained.

A question was raised concerning the quality of tax return preparers and the problems of encouraging good and discouraging bad performance within the industry. Professor Schenk indicated that the problem was the same for preparers as for taxpayers. One response, it was suggested, would be the establishment of a government incentive program that would, in effect, subsidize the development of high quality professional assistance. Such a plan would not, however, deal with the many unpaid tax return preparers who provide assistance to friends and relatives.

It was suggested that the Internal Revenue Service expand its education program to include tax return preparers. Another conferee observed that the use of tax return preparers by low-income taxpayers may create a second kind of lottery that will evolve because the tax preparer, by not eliciting sufficient information, will contribute to the filing of erroneous returns. In effect, therefore, the tax return preparer is used as a defense against the possibility that the accuracy of the return would be questioned by the Service.

One participant suggested that the distinction between simplicity for the tax return preparer and for the taxpayer might be illusory. The evolution of simplicity for tax return preparers would also directly affect the ability of taxpayers to prepare their own returns. Professor Schenk agreed and stated that she was suggesting only that the tax return preparer be identified as the standard. The achievement of simplicity for the standard would create benefits for the same reasons as for the taxpayers themselves.

The establishment of the tax return preparer as the target was criticized on the ground that it is an inappropriate goal. There is a need to maintain contact between the taxing system and the average intelligent person. The average intelligent citizen must believe that the system is at least understandable and that he can prepare his own return if he makes the effort. Professor Schenk restated her belief that this goal was probably unattainable.

One participant suggested that there had been too much concern about long-range goals. It might be more helpful for the Conference to focus on more short-term objectives. For example, the establishment by the Internal Revenue Service of a staff adequate to bear the burdens

of issuing regulations promptly would be desirable. Also a few areas of peculiar substantive complexity could be identified and established as priority vehicles for the development of simplification objectives.

It was suggested that predictability and simplicity are not necessarily synonymous. For example, although the Clifford Trust rules may increase predictability, they are not simple.

3

Simplification for Individual Taxpayers

Session: Thursday Afternoon, January 5, 1978

Moderator:	Harvie Branscomb, Jr.
Panelists:	Martin D. Ginsburg William M. Goldstein Frederic W. Hickman Harry K. Mansfield
Commentators:	David G. Glickman James M. Verdier James W. Wetzler

This session was organized to deal with a number of specific issues that primarily affect individual taxpayers. Mr. Branscomb observed that progress toward simplification might be achieved by such means, even though larger proposals for general simplification of tax laws might not be attained at the present time.

Harry K. Mansfield discussed aspects of simplification and personal deductions.[1] He cited several recent changes in the tax law that have increased simplification to some extent. During the last tax year, only 25 per cent of individual taxpayers itemized personal deductions. That percentage may decline to less than 20 per cent during the present year. He noted, however, that this data may be somewhat misleading. Tax-

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* Harvie Branscomb, Jr., is a partner of Branscomb & Miller, Corpus Christi, Texas.
Martin D. Ginsburg is a member of Weil, Gotshal & Manges, New York, New York.
William M. Goldstein is a member of Morgan, Lewis & Bockius, Washington, D.C.
Frederic W. Hickman is a member of Hopkins, Sutter, Mulroy, Davis & Cromartie, Chicago, Illinois.
Harry K. Mansfield is a member of Ropes & Gray, Boston, Massachusetts.
David G. Glickman is a member of Jenkens & Gilchrist, Dallas, Texas.
James M. Verdier is Deputy Assistant Director for Tax Analysis of the Congressional Budget Office.
James W. Wetzler is Chief Economist of the Joint Committee on Taxation.

[1] Mr. Mansfield's Conference Paper is reproduced in Appendix II, pp. 205-21.

payers who do not itemize may have to maintain detailed records sufficient to lead them to that decision.

Mr. Mansfield proposed as a beginning step the elimination of deductions for gasoline taxes and, possibly, for state sales taxes. Further, he recommended higher floors for medical expense and casualty loss deductions and the consideration of a tax floor for charitable contribution deductions. These modifications would, however, achieve only a modest degree of simplification.

Mr. Mansfield noted that the substitution of credits for deductions, although supported by considerations of equity and efficiency, would not necessarily increase simplification. Nor would the substitution of governmental grants for tax expenditures necessarily result in overall simplification.

Frederic W. Hickman discussed the impact of capital gains provisions on the complexity of the tax structure.[2] He offered some general conclusory observations. Simplification arguments in connection with capital gains are often made to buttress positions concerning whether the tax itself should be higher or lower. The capital gains structure is the result of compromise, not the result of intellectual clarity or principle. Compromise generally means increasing complexity. The computation of gain is necessarily complex. It is not possible to consider the problem of complexity without considering the validity of underlying premises. Simplification cannot justify the adoption of bad laws. A beginning step toward simplicity might be to consider anew the minimum tax and the treatment of preferences in the maximum tax, which essentially constitute indirect methods of changing the structure of capital gains. The new, very high inflation rate compounds these problems.

Mr. Hickman concluded that no major gains toward simplification would result from taxing capital gains at ordinary income tax rates.

Martin D. Ginsburg discussed complexity in the real estate industry.[3] Mr. Ginsburg considered two aspects of the real estate industry: homeowners and investors. The deductibility of interest and taxes for personal residences is somewhat misleading. Since the deductions are below the line, those taxpayers who take a standard deduction do not benefit. The tax rules that apply for real estate investors have generated entire industries and tax-sheltered arrangements. There are ways to address this kind of complexity. One might be to apply the "at risk" rules to realty. Also there might be some useful reform in the depreciation rules.

[2] Mr. Hickman's Conference Paper is reproduced in Appendix II, pp. 223–53.
[3] Mr. Ginsburg's Conference Paper is reproduced in Appendix II, pp. 255–75.

William M. Goldstein discussed simplification in the treatment of compensation.[4] One way to achieve simplification in respect to fringe benefits is to value all benefits at the time they are received. At that time, it is both income to the employee and a deduction to the employer. There would, of course, be a number of valuation and other problems. There would also be two major exceptions to the proposal. One is addressed to qualified pension plans. The second involves unemployment compensation and the social security system, which are mandated by law. In these latter situations, Mr. Goldstein proposed that the employee be taxed at the time of distribution.

Mr. Goldstein would favor taxing fringe benefits at their market value, rather than at cost to employers. There would be no insuperable problem in valuing most of the other statutory exclusions if they were to be taxed because a market value is generally determinable. Mr. Goldstein noted that he was a strong advocate of the comprehensive tax base, a position leading directly to the conclusions suggested in his paper.

David G. Glickman commented on problems of complexity in the oil and gas industries. Although many of the issues that generally arise are relevant to these industries, there is a particular vocabulary and some peculiar principles and concepts that apply only with respect to oil and gas.

There are two basic concepts that are trigger mechanisms in the taxation of oil and gas: the deductibility of intangible drilling and development costs and the availability of percentage depletion deductions. Both of these benefits derive from the special characteristics of the industry—high risk investment and physical depletion of the assets.

The Tax Reform Act of 1969 was the first successful legislative attack on oil and gas tax benefits. The 1969 Act eliminated the ABC transaction and the carved-out production payment arrangement. It also reduced the rate of percentage depletion and included as a tax preference item percentage depletion deductions. The Tax Reduction Act of 1975 generally eliminated percentage depletion except for independent producers and royalty holders . The Tax Reform Act of 1976 reduced the advantages of intangible drilling and development costs. Their value is further diminished by the Tax Reduction and Simplification Act of 1977. The trend is likely to continue.

These arrangements clearly caused complexity in the tax laws. Moreover, the provisions tended to generate complicated transactions. The

[4] Mr. Goldstein's Conference Paper is reproduced in Appendix II, pp. 277–94.

elimination of the provisions has clearly simplified the tax law in some ways. The effect of the changes, however, will be to reduce the number of taxpayers involved in the oil and gas industry. This, in turn, will effectively diminish the potential for investment in the industry. Mr. Ginsberg questioned whether this was an appropriate time for such a change of attitude. Moreover, although the changes benefit particular taxpayers, it can be argued that the previous arrangements had created a degree of simplicity in themselves.

Initially, the changes may have led to a degree of simplicity. Beginning with the Tax Reduction Act of 1975, however, simplification objectives were sacrificed in the name of tax reform. Moreover, the administrative response to these changes has created additional degrees of complexity. The net effect of these developments has been to convert what was a moderately complex area of the law into an extremely complex area that may serve as a typical example of dynamic complexity.

James W. Wetzler commented on the treatment of personal deductions and capital gains. He agreed with the conclusion that the outright repeal of itemized deductions would achieve little simplification. The establishment of floors would reduce recordkeeping and be politically feasible. Mr. Wetzler expressed skepticism, however, with respect to the floors. A floor may serve as a *de facto* repeal of a deduction if it is high enough. If the floor is too low, it will not substantially affect taxpayer conduct. Within the intermediate range, the degree of effectiveness will vary.

The principal device for achieving simplicity has thus far been to enlarge the standard deduction. Mr. Wetzler noted that this approach is costly in terms of revenue collection and observed that there is very limited opportunity for further use of this device. He expressed the view that the evolution of an increasing number of credits, defined by increasingly complicated provisions, is the main source of the new complexity.

Mr. Wetzler also agreed with Mr. Hickman's general conclusions that those changes in the capital gains structure that are politically feasible are not likely to simplify matters. He suggested that carryover basis is the route to maximum simplicity. He suggested that the elimination of the minimum tax could be achieved by a revenue neutral proposal providing an exclusion of about 43 or 44 per cent for capital gains. Further, Sections 1201 and 1231 and the transitional rule for pre-1970 capital losses could be repealed without substantially changing a taxpayer's burden.

James M. Verdier commented on simplicity and tax expenditures. He stated that tax expenditures are often inserted in the tax code because they would be difficult to justify on their merits and are thought to be self-administering. Eliminating tax expenditure subsidies is likely to increase complexity, at least during a transition period. He cited the complex recapture rules on different forms of depreciation and the minimum and maximum taxes as examples of this process. The definition, in stringent terms of eligibility requirements for tax benefits, may also lead to complexity. Moreover, if a dubious subsidy were simply transformed from the tax system into a direct subsidy arrangement, little would be gained. He observed that from a tax standpoint bad tax expenditures most often reflect bad public policy.

The panelists then discussed the elimination of capital gains. Mr. Ginsburg favored the elimination of the capital gains deduction if it were accompanied by a 50 per cent maximum tax and if capital losses were deductible. Mr. Hickman did not favor such a modification unless there would be an inflation adjustment. Mr. Ginsburg suggested that capital gains would have to be taxed fully at death in order to avoid a massive giveaway of tax revenues. Dean Griswold stated that the validity of imposing a tax on unrealized capital gains at death was not necessarily obvious. The income tax and the estate taxes are complementary and serve as components of a single taxing system. The imposition of the estate tax represents a balancing of conflicting objectives.

The practical politics of the situation were discussed. Mr. Verdier indicated that he believed that the elimination of the capital gains deduction could not be accomplished as a political matter without an inflation adjustment. It was, of course, recognized that inflation adjustments might create areas of complexity that do not presently exist. Mr. Wetzler pointed out that an inflation adjustment, to be consistent, would have to apply to other transactions as well as to basis adjustments for capital gains recognition. For example, debts might be adjusted so that debtors would realize income to the extent that inflation had eroded the real value of the debt. Interest rates, however, at least in part, reflect inflation anticipation. Mr. Wetzler favored inflation adjustments in the indexing of depreciation deductions. He pointed out that inflation adjustments could be very complicated, especially when improvements had been made to the same capital asset in different taxing years.

Mr. Goldstein questioned whether it was appropriate to discuss simplification with the assumption that revenues would be maintained. If tax expenditures were removed, additional revenues might be re-

quired in order to fund direct subsidy programs. Mr. Ginsburg observed that if subsidy programs were administered by particular agencies, at least fewer citizens would be concerned about their administration and affected by it.

The discussion was then opened to all conferees. One participant emphasized that practical considerations must be taken into account in the interpretation of statutory rules. In the fringe benefit area, for example, the assertion of a purist principle that the provision of value by employers to employees is income is not always enforceable. Moreover, an attempt to enforce such interpretations literally would add to the confusion and complication. In many instances, an attempt to arrive at a comprehensive tax base might add confusion.

It was suggested that constitutional issues may arise if charitable contributions were converted to direct subsidies, particularly if the financing of churches were involved. In response, one conferee stated that the conceptual constitutional issue may be no more difficult with a direct matching grant than with the present deduction arrangement. Furthermore, revisions in the procedure for considering tax expenditures may highlight the constitutional issues.

The substitution of a direct subsidy in the charity area was criticized on the ground that there would be merit in retaining the private choice aspects of the present system, which removes political considerations in the allocation of resources for charitable objectives. Mr. Goldstein responded that many charities—perhaps the best—would survive even without the benefit of a tax expenditure. He noted that many charities flourished prior to the income tax and that many individuals contribute to charities even though they use the standard deduction.

It was suggested that Section 102 might be repealed to render transfers by gift and by bequest income, with a modest annual exclusion, and that the federal estate and gift tax could then be eliminated.

One participant suggested that the removal of a deduction might not have consequences of the extreme magnitude that some would predict. By reducing the effective tax rate to 50 per cent, there is a potential reduction of the 20 per cent tax benefit for any personal deduction, such as home ownership or charity. Such a reduction did not seem to worry anybody, however, when the rates were changed.

One proposal offered as a way of dealing directly with fringe benefits was to impose an excise tax of 25 per cent on untaxed fringe benefits. This would protect the public revenues and serve as an approximation of the income tax that would be imposed with great ease. Mr. Goldstein

indicated that the proposal was not necessary, since it was possible to determine the fair market value of most items. Other conferees believed that the problems of valuing fringe benefits among different beneficiaries would be extraordinary.

It was suggested that changing the tax law to encourage the payment of direct benefits, rather than fringe benefits, could achieve substantial simplification objectives. If the law could encourage employers to pay employees in cash rather than in subsidized benefits, the administration of the law would be materially simplified.

There was strong sentiment in support of specific, if modest, steps toward simplification. Several participants expressed the view that this would be the only way to achieve any sort of simplification.

4

Problems of Managing the Complexity of the System

Session: Thursday Evening, January 5, 1978

Moderator: Stanley S. Surrey

Panelists: M. Carr Ferguson
Ward Hussey
Jerome Kurtz
Stuart Seigel

MR. ERWIN GRISWOLD: The hour of 7:30 has arrived and passed and I think we ought to proceed with the very interesting program that we have this evening. I won't introduce the speakers because that will be done by Professor Surrey, but I would like to say that we are very grateful to these public officials for taking their time and energy to come here and join us in this survey of the possibilities and potentialities of tax simplification.

We can't get away from Stanley Surrey no matter how hard we try, and we don't try very hard, and he is the moderator of this evening's program. Professor Surrey.

MODERATOR SURREY: This is a very unusual panel. It's rare that the villains in the piece are willing to come out in front of the audience, or the torturers are willing to come out in front of the tortured, and I could go on in this way for quite a long time. But I do think this is one of the most unusual panels that has been put together for any

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* Stanley S. Surrey is a Professor of Law at Harvard University Law School, Cambridge, Massachusetts.

M. Carr Ferguson is Assistant Attorney General (Tax Division) of the United States Department of Justice.

Ward Hussey is Legislative Counsel in the Office of the Legislative Counsel of the United States House of Representatives.

Jerome Kurtz is the Commissioner of Internal Revenue of the Internal Revenue Service.

Stuart Seigel is Chief Counsel of the Internal Revenue Service.

[EDITOR'S NOTE: No Conference Papers were prepared for this session of the Conference. The following transcript of the session has been reviewed and edited by the panelists.]

conference I know. Each of the panelists will discuss his topic for about 10 minutes, and then we will throw the matter open for questions from the audience.

There are some changes on the panel. Don Lubick will be on tomorrow afternoon's panel, and on this panel, not necessarily in his place, is Stuart Seigel. I've given him permission to comment or not comment as he chooses, but in any event, he will be glad to participate in answering questions.

The first discussant this evening will be Ward Hussey, the House Legislative Counsel and, I think as everyone here knows, the draftsman of the federal tax legislation for a large number of years. Ward.

Mr. Ward Hussey: Unlike my appearances in Dean Griswold's tax classes, I came prepared with an outline of my remarks.

The best way to have simple tax laws is to have a simple tax policy. Each added policy requirement usually adds complexity. Each additional refinement of policy usually adds words to the statute, although it may well make the application of the statute more certain.

Which is reason enough to pause for a moment to reflect on the words *simple* and *complex,* as related to a statutory provision. For purposes of these remarks, I intend to use *simple* to mean that, given the scope of the legislative policy being embodied, the provision is not hard to understand in the abstract and not hard to understand in its application. I intend to use *complex* as the opposite of *simple.*

With these meanings for the words *simple* and *complex,* the categorizing of a statutory provision may differ from the commonly accepted categorization of that provision. For example, a statute in which there is an effort to face up to the problems of internal coordination of its parts, of external coordination with other provisions of federal and state laws, and of how it is to be administered, while much longer than a statute which ignores these problems, may well be far less complex.

Given this meaning for *complex,* the legislative drafter has a vital role in managing the complexity of federal tax laws. The drafter's first job is to analyze the legislative proposal, to separate out its major and minor thrusts. Much of the complexity in our statutes, much of the gap between the way it was hoped the statute would work and the way it *does* work (or does not work) can be blamed on a failure (whether because of too short a deadline or otherwise) to identify the problem clearly and to explore in depth the ramifications of the proposed solution to the problem.

In the process of analysis, parts of the original proposal often are seen

to be unnecessary or in need of modification. The avoidance of any unnecessary trip into a statutory brier patch is a clear victory for simplicity. Then, too, in the course of the analysis, gaps in the original proposal will turn up. These must be filled if the application of the proposal in these areas is to have any degree of certainty.

This process of analysis, of thinking the proposal through, should be the most time-consuming part of preparing the statute. Indeed, a trained drafter may well spend more than 95 per cent of the available time on analysis, less than 5 per cent of the time with pencil on pad, fingers on the typewriter, or mouth open dictating. It is in the area of analysis that the drafter's greatest contribution to simplicity may be made.

But assume that the drafter has adequately performed the primary function of legal analysis. What else may the drafter do to nudge the finished statute from the complex toward the simple?

At this point, I am tempted to turn to the Internal Revenue Code of 1954. Not so much with pride as with a conviction that it could be a lot worse. Given the inherently complicated nature of the subject matter, the myriad of transactions and circumstances which it purports to cover, and the importance of its rules to the persons affected (and to their attorneys, accountants, and other representatives), I believe that the Code compares favorably in simplicity with other federal and state laws.

The Code has a logical organization in its subtitles, chapters, subchapters, parts, subparts, and sections. There is a good chance that similar subject matters will be dealt with in the same area of the Code. Within the section, there is an expectable organization—a general rule followed by special rules or exceptions. There are defined terms to increase the certainty of the words used. There are readability aids, such as headings (which, under Section 7806(b) of the Code, are not to be given any legal effect) and indentations, an attempt to use English instead of Latin, and an attempt to shorten the sentences. Over the years there has also been an attempt to incorporate into the Code matters of more general import, placing special temporary provisions of limited application in statute law outside of the Code.

There seems to be unanimous agreement, however, that much more should be done to simplify our tax laws. Professor Surrey, in *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail,* 34 L. & CONTEMP. PROB. 703 (1969), has suggested that there should be a combination of more generalized statutory provisions with a "clear delegation to the Treasury Department to amplify the

statute through regulations with details to whatever depth is necessary for the effective operation of the statute in that particular area."

Over the years, Congress has often delegated such authority to the Secretary of the Treasury. One example which comes to mind is the massive grant of authority with respect to consolidated return regulations made by the 1942 Revenue Act. The trend towards such delegation seems to have strengthened in recent years. Indeed, there have been occasions when the general authority granted to the Secretary of the Treasury to prescribe regulations by Section 7805(a) of the Code has been supplemented by a second grant of such authority within the section or subpart being added; and then, with respect to particularly troublesome areas of that section or subpart, there has been a third grant of authority to prescribe regulations. For example, the credit for the employment of new employees, which was added to the 1954 Code by Section 202 of the Tax Reduction and Simplification Act of 1977, did not rely solely on the language of Section 7805(a) of such Code, which directs the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement of this title . . . ." Thus Subsection (b) of Section 44B of the Code provides that the "Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart D." In addition, when the statute came to the particularly thorny requirement that all employees of trades or businesses which are under common control are to be treated as employed by a single employer for purposes of the new employment credit, there was further explicit grant of regulatory authority. The second sentence of Section 52(b) of the Code provides that these regulations with respect to businesses under common control are to be "based on *principles similar* to the *principles* which apply in the case of subsection (a)," that is, similar to the principles applicable to controlled corporations.

Some would argue that this is sufficient delegation to warm the heart of any regulation-writing empire builder.

However, what is perhaps the ultimate to date in the delegation of regulatory authority is set forth in Section 167(l)(5) of the Code, which was added by the Tax Reform Act of 1969. Section 167(l)(5) provides, in effect, that if by reason of any circumstances the application of any provisions of Section 167(l) (dealing with reasonable allowance for depreciation in the case of certain utility property) does not carry out the purposes of Section 167(l), the Secretary of the Treasury shall provide by regulations for the application of such provisions in a manner consistent with the purposes of Section 167(l).

It is interesting to note that paragraph (5) of Section 167(l) was added to the Code by the Tax Reform Act of 1969 (which was enacted on December 30, 1969), that regulations reflecting in part the provisions of such paragraph (5) were adopted June 6, 1974, but that as of today, regulations fully implementing such paragraph (5) have not been prescribed, even though eight years have passed since its enactment.

More systematic delegation of authority to fill in the details is certainly a technique to be borne in mind in the quest for simplicity. But it is a technique which should be used only with the realization that the complexity of our tax laws should be judged not on the basis of the statute alone but also by taking into account the regulations, rulings, and decisions which must be understood if the statute is to be understood.

In any case, it is to be hoped that in any delegation, the statute itself will set out, with as much clarity and certainty as possible, the standards which are to be followed by the regulation writer. It is to be hoped, too, that the Treasury or other agency or body receiving the delegation will explore methods of insuring objectivity and continuity of service of those to whom the preparation and approval of the regulations is entrusted. Finally, it is to be hoped that steps will be taken to speed up the regulation-writing and approval process.

There are many ways in which statutory drafting could be improved. One of the ways which I would like to see explored is greater use of "horizontal" drafting.

In a sense, the income tax provisions of Chapter 1 of the Code represent "vertical" drafting, that is, one substantive area of the income tax laws is dealt with in depth in one subchapter. Thus one expects to find matters relating to corporations in Subchapter C, matters relating to estates and trusts in Subchapter J, and matters relating to partnerships in Subchaper K. This contrasts sharply with the treatment of administrative matters in Subtitle F, where matters relating to assessment of deficiencies, to refunds, to interest, and so forth are set forth in one place, even though they have application across the boundaries of the income tax, the estate and gift taxes, and the other excise taxes, and even though they apply to all types of taxpayers.

My use of the adjective "horizontal" here is admittedly arbitrary and is made because I can't think of a more descriptive word. What I intend to encompass is any provision of law which has application across the borders which divide two or more subject areas. Thus what I am here calling "horizontal" drafting includes the definitions of general application contained in Section 1 of Title 1 of the United States

Code and the 36 definitions contained in Section 7701(a) of the 1954 Code.

"Horizontal" drafting also includes the much maligned incorporation by reference. I believe that it is often possible, by incorporating rules by reference instead of spelling them out, not only to use far fewer words in the statute but also to provide more understandable, certain, and consistent results. For example, Section 2006 of the Tax Reform Act of 1976 added a new Chapter 13 to the Code dealing with generation-skipping transfers. How was the new chapter to be administered? The answer, set forth in Section 2621(a) of the new Chapter 13 of the Code, is that the administrative provisions (including penalties) which apply in the case of the estate tax or the gift tax (whichever is more appropriate to the transfer in question) are to apply to generation-skipping transfers. I submit that this is a better technique than amending each relevant provision of Subtitle F which the drafter can find in such a way that the policy enunciated in Section 2621(a) is carried out.

But I am not here advocating wider use of definitions of general application or of incorporation by reference. What I am recommending is exploring the possibility of treating on a more general basis recurring problems in the tax laws. What I have in mind is the incorporation into the Internal Revenue Code of general rules which would apply except to the extent otherwise provided in a particular provision. A precedent for this is Section 21 of the Code, which deals with what happens when the rate of a tax changes during a taxable year. This section has worked so well that its application has on occasion been extended to changes in the amount of the personal exemption, standard deduction, and surtax exemption. There are obvious dangers in generalized provisions of this kind, not least of which is that the drafter may not have sufficient time to determine the needed special rules and exceptions for the particular area in question. But I believe that in many cases the advantages will outweigh the disadvantages.

The difference in drafting technique being suggested can be seen by comparing H.R. 8989 of the 94th Congress, as introduced, with H.R. 4089 of the 95th Congress, as reported by the Ways and Means Committee. Both bills provide that, for certain income and excise tax purposes, Indian tribal governments are to be treated as if they were states. To accomplish this result, the introduced version of H.R. 8989 inserted amendments relating to Indian tribes in some 22 provisions of the Code. H.R. 4089, as reported, dealt with the matter through one generalized provision in Subtitle F (placed in a new Section 7871 contained in a new subchapter of Chapter 80 entitled "Subchapter C. Provisions

Affecting More Than One Subtitle"), in one definition in Section 7701, in one additional subsection in Section 103 of the Code dealing with industrial development bonds (where the policy called for additional detail with respect to the issuance of obligations by Indian tribal governments), and in cross-references to the new Section 7871 in the principal provisions of the Code affected by the bill. By this change in technique, the understandability of 21 provisions of the Code as they apply to states and to political subdivisions of states was not impaired. At the same time, the understandability and certainty of the application of these provisions to Indian tribal governments (and to their subdivisions) was probably increased.

When and how extensively "horizontal" drafting should be used are obviously judgment calls. However, it is possible that agreement could be reached as to areas in which general rules would give greater understandability and certainty of application after they have been fleshed out by regulations and by administrative and judicial interpretations. Could agreement be reached on any of the following for purposes of the income tax?

(1) A rule for applying dollar limitations (the policy for which is usually established by reference to one taxpayer who is an unmarried individual) in the case of

(a) Married individuals filing joint returns and married individuals filing separate returns

(b) Partnerships, Subchapter S corporations, trusts, and estates

(c) Corporations (other than Subchapter S corporations)

(d) Related entities

(2) A rule setting forth when individuals are to be treated as married and when they are to be treated as not married. (The trend in this area seems to be towards following Section 143(b) of the Code, but it is not yet a universal trend.)

(3) A rule relating to the treatment of income which constitutes community income under community property laws

(4) More uniform rules for carrybacks and carryforwards (not the years to which an item may be carried, but the order in which they are to be applied and the way in which they are to be used up)

(5) Patterns for transitions, including phase-ins, phase-downs, and phase-outs. (I use the word *patterns*, rather than *rules*, because of the extraordinary ingenuity of the human mind in recent years in devising different transitional rules.) The goal here would be to draft a provision

similar to Section 21 of the Code so that in the future the statutory command could simply be that the change in law is to take effect in the specified number of stages.

If progress is made in these areas, a second step might be to explore more difficult areas, such as more uniform constructive ownership rules and more uniform rules for the tax treatment of pass-through entities and their beneficiaries.

A third step might include work on general rules for construing the Code. Here, great caution would be in order. It is arguable whether in the long run such rules would result in simplification and certainty of application. For example, suppose that a future Congress were to add to Chapter 80 of the Code a section stating, in effect, that the provisions of the Code are to be applied to the substance of transactions, rather than to their form. How many provisions designed to prevent avoidance, how many provisions designed to prevent "narrow bureaucratic interpretations," could be omitted because of the effects of this new section? More importantly, would there be greater or less certainty as to the application of particular provisions of the Code?

In a similar vein, the introductory language of Section 7701(a) of the Code provides that "When used in this title, where not otherwise distinctly expressed *or manifestly incompatible with the intent thereof* (italics added) . . ." certain definitions are to be applied throughout the Code. Would the cause of managing the complexity of the tax laws be aided by a general rule of construction that no provision is to be construed in a way which is manifestly incompatible with the purpose of the provision?

Reasonable individuals will differ in their answers to the questions raised in the foregoing paragraphs on general rules for construing the Code. And reasonable individuals will disagree on the merits of "horizontal" drafting. But one thing should be made clear—tax drafters yield to no person in their desire to simplify the tax laws.

MODERATOR SURREY: Thank you, Ward. We are proceeding in this discussion from the legislative to the administrative and then to the judicial. We can leave it open for later discussion as to whether you agree or disagree with him on all that Ward has said. I'm inclined to agree with him. Having grown up under his predecessors and learned my legislative drafting from his predecessors, I know the school of drafting that he is espousing, and I have to agree with it.

The next speaker on the program is the one that has the burden of carrying out the work that Ward drafts and that's the Honorable Jerome Kurtz, Commissioner of Internal Revenue.

MR. JEROME KURTZ: I learned everything I know about legislative drafting from Ed Kraft and Ward Hussey. That amounted to drafting one statute one time when I was tax legislative counsel. I had drafted a four-line section on the suspension of the investment credit that seemed completely adequate to me. I remember handing it to Ed Kraft who, with an assembled crowd, was sitting around a table at a drafting session. Ed opened a drawer in the table, put the draft in, closed it, and then we proceeded to discuss the basic policy issues involved. That was the last time I tried to draft a piece of legislation. [Laughter]

I have the greatest respect for those who can. We've talked a lot about simplicity and complexity today from various points of view. From our vantage point at the Service and looking at 84 million returns being filed, I must say that the problems of Subchapter C don't seem terribly important directly.

The problems concern more the great bulk of taxpayers, the ones whom Miss Schenk talked about today, who are baffled and intimidated by the system, with, let me say, considerable justification. At one point earlier in today's discussion when there was talk about adopting a very comprehensive low-rate tax base, as has been suggested, someone said that's a political impossibility and we ought to start with more attainable objectives.

A little later on, it was suggested that the Service could manage complexity a lot better if it had a lot more agents. I submit to you that that is an equally unattainable political goal. There is no indication on the part of Congress nor on the part of the administration to expand the IRS in any significant way and that certainly has been the history for many years. So the problem is not how to manage complexity, because I think it would be much easier if we had open-ended resources, but how to manage complexity given the existing resources or with very small supplemental resources. I see Sheldon nodding a knowing grin at that.

The problem is how to manage the tax system given resources which only allow for an audit coverage of 2.4 per cent or perhaps less, which allow us to answer hopefully 80 or 85 per cent of the taxpayers if they persist in calling three or four times, and which require that taxpayers wait an hour or more in line at offices during filing season. These are all problems which are easily solved with resources, but it is something else to spread resources to most efficiently handle the problems of taxpayer service and audit.

I'm reminded of a story that I first heard when I was at the Treasury some years ago. I guess it was told to me by someone at IRS and now I,

for the first time, fully appreciate the irony of it. The story was about a rabbit who was very unhappy and went to see a psychiatrist. The psychiatrist asked him what the trouble was, and the rabbit went on and on about how very unhappy he was with the way he looked, how he wished he had beautiful feathers instead of fuzz, and how he dreamed about being able to fly and swim. The psychiatrist finally said, "Well, I have the solution to your problem, rabbit, you should be a duck." And the rabbit said, "That's marvelous. I think that would answer everything. How do I do it?" And the psychiatrist said, "I just make policy."

The other aspect of the problem which Sidney Roberts discussed relates to complexity and the high-income, sophisticated taxpayer. And that's a problem to us to the extent, and I believe it's a real extent, that it creates the impression, an impression based on fact, that high-income taxpayers are not paying their full share of the tax. That is a problem in our view. Obviously, the success of the tax system depends on taxpayers voluntarily complying with it.

But audit coverage at the level of 2, 3, 4, or even 5 per cent can only be successful if it is based on a system which has a large element of voluntary compliance in it. If people, by and large, decided they were not to pay their tax, any enforcement effort, even double what we have today, would be of very little avail. Any voluntary compliance depends on a sense of fairness in a system which, in turn, depends on most taxpayers sensing that others are paying their just share. These feelings, which are directed at the upper end of the income stream, have to do with complex transactions and, to a considerable extent, with what Sidney described as the audit lottery, that is, the problem of high-income taxpayers, in particular, calling the shots in their favor because there is an argument for their position, and if they are wrong, the penalty is to pay the tax and interest at what is usually a bargain rate.

So there's considerable incentive for the taxpayer to call the shots in his own favor. The problem we face in administering this system is how to take very limited resources and spread them in a way to cope with the most sophisticated taxpayers and the most sophisticated kinds of transactions. One thing that we have focused on recently, and in a sense it's a case study of what's involved in doing this, is in the tax shelter area, where we felt that there were significant abuses. Congress has permitted certain tax shelters, but promoters and others have pushed these to the limits, in some cases beyond the limits, and have created or have contributed to an impression that high-income taxpayers probably are not paying their share.

So we try to cope with this. What's involved in doing that? Well,

first we have to find the returns that are likely to be involved, and this means programming our computers to select them. But having selected these returns, we then have to audit them. But it's an area that has not been heavily audited before, and our agents are not particularly familiar with it. So we are starting a massive training effort. In doing this, we've developed hundreds of pages of training materials dealing with partnerships and shelters. We are running pilot training in Washington for a large group of very sophisticated agents and managers who will then go out to their regions and re-give the course.

The partnership area presents another major management problem in the sense of now controlling numerous cases, as compared with the very limited partnership program last year. We now have well over 20,000 cases in suspense because when we audit a partnership which has 500 partners all over the country, we have to find those returns and put them in suspense until the partnership issues are resolved. This creates substantial backlogs.

If any significant number of those taxpayers decide that they would like to litigate the issue, the tax court could well find itself deluged with cases. We're developing a computer system to control these cases and to watch the statute of limitations.

The point is that it's a very complex matter within the Service, requiring substantial allocation of resources from other programs to try to handle one particular area which appears to be a problem. I might say now that we've increased our activities in the partnership area, and I think that's fairly well known. The next move has been for promoters to promote ventures which they classify as not being partnerships. What we now have is each person owning a dozen mink on the mink farm, each person owning two feet of a vein in the gold mine, or one square foot of the coal mine. And these ventures are not filing partnership returns.

Well, some may ask, "What's the difference?" But the problem is how do we find those returns? It's interesting to note that the preliminary statistics for returns filed this year indicate that there are 6,000 returns with zero adjusted gross income but with an average preference tax of over $5,000 per return. We traditionally have classified returns for audit coverage by AGI, so if a person is really well sheltered and is in the zero to $10,000 AGI class, his audit coverage is less than $^{6}/_{10}$ of 1 per cent.

Therefore, we are undertaking a study to determine whether we can classify returns on a basis other than AGI, for example, on a basis of

total gross income without minuses. But this is difficult and requires reprogramming computers.

The point is that there is considerable administrative complexity in trying to handle taxpayer gambits, particularly in trying to handle them with very limited resources, and this gets me to what Sidney described earlier as the audit lottery. Should we be content to audit $\frac{6}{10}$ of 1 per cent of under $10,000 AGI returns and if someone very wealthy happens to pop up in that sample, so much for that?

I find it very disturbing that we're dependent on that kind of coverage. Even in the highest income levels, as you know, our coverage is very low, and the question is why we should be dependent solely on our own resources when there are a lot more resources out there. Accountants and lawyers know a lot more about the tax returns they prepare than we do. They have all the information in their files dealing with these returns, a lot more than we do.

At a meeting in the Boston district recently, I met with the liason group. We discussed whether there shouldn't be some obligation on taxpayers or others to disclose items that we might be interested in, and one of the lawyers said, "Well that's really not fair, this is an adversary system." I think that's a basic misunderstanding, and I'm sure you'd all agree with that. This is not an adversary system.

It's a self-assessment system, and it depends on the taxpayer. Our audit coverage would be much more effective and our administrative problems would be much less if taxpayers would disclose to us a bit more than they do. And I frankly can think of no reason why they shouldn't, other than because of the complexity issue. I think we have a duty not to impose a burden on taxpayers, particularly the unsophisticated, which adds significantly to the complexity of filing a return. But we are working on, and hopefully we will have some success at, devising additional reporting by that class of taxpayers most able to report to us information that would be helpful in identifying those returns that we ought to be auditing.

The system simply cannot function, in my view, in the long run if very sophisticated taxpayers engage in very sophisticated transactions, bury the results of those transactions in some line on the return, and then leave it to us to find the return, find the item, raise the issue, and litigate it. This is not so much because of the tax involved with that taxpayer, but more because of the need to maintain respect for the system.

Another complicating factor is the problem we face when having to

stand still against events which are moving. I would put in this category fringe benefits and the employer-independent contractor question. If questions about fringe benefits had never been asked, my life would be simpler and I would have more time to spend with my family.

But they do come up, and when we don't give answers, we have to start suspending cases. Now there are about 40 technical advice memoranda pending on different fringe benefit issues, and, as a result, there are thousands of audits in suspense. It's very difficult to stand still, and yet Congress has taken the position in this area and in others that the Service do or not do something either by statute or in committee reports, without assuming the legislative responsibility for solving the problem. This has been happening with increased frequency in recent years, and I think it's a very disturbing trend.

I must say that when I was Tax Legislative Counsel, I felt very strongly about whether a particular fringe benefit was taxed or not as a matter of equity. Now knowing what the answer is is no longer a question of equity. The most difficult thing is to sit without an answer, to pile case upon case in suspense, and to have agents who justifiably, with initiative and with brightness, raise questions; and we can't give them an answer. It's demoralizing to the Service, and it's difficult to administer the system that way. If Congress wants to undertake the problem, I hope they do. In the meantime, it seems to me either they have to solve it or leave it to the Service or the Treasury to solve, but not simply halt all action.

I might say that there is a byproduct in the Ways and Means Committee Bill on fringe benefits. The Committee reports said that we should continue existing administrative practice, and I suppose that blesses the cafeteria ruling. [Laughter]

Moderator Surrey: I do think the Commissioner has given us a lot to discuss later on, and I'll withhold my comments now on some of his interesting points. There are, of course, a number of lawyers who always say, "We'll fight the Commissioner and take him all the way to the Supreme Court." There's an obstacle in going to the Supreme Court, and that obstacle is here, in the presence of Honorable Carr Ferguson, an Assistant Attorney General, Tax Division.

Mr. Carr Ferguson: While Congress may direct the Internal Revenue Service to freeze or to develop tax administration in certain areas, Congress cannot dictate decisions reached by the courts in tax controversies, nor can it tell taxpayers what issues they can bring to the court's attention. At this moment, we have employee-independent contractor cases

involving issues that may soon be subject to legislative resolution pending in the court of claims. But the courts are not going to wait for legislative resolution. They feel they have waited long enough for Congress to act, and they plan to take the initiative.

It seems odd to view the litigative tail on this enormous tax administrative dog as having any kind of control over the administration of taxation. I suppose it ought not to. The role of the Tax Division of the Department of Justice and of the Chief Counsel of the Internal Revenue Service, insofar as litigation goes, is to represent the government's views before the courts and to assist the courts in structuring sound interpretations of the tax law.

Our role is more restrictive and much more modest than the role of the legislator or the administrative interpreter and applier of the tax laws. Our only instruments of policy formulation are passive and negative. We can refuse to litigate. We can refuse to go forward with a particular argument in some cases in order to achieve or protect administrative and legislative options. A recent example was the recommendation which the Tax Division made to the Solicitor General's office to withdraw the government's appeal in the *Larsen* case in the Ninth Circuit. This decision was literally reached at the eleventh hour, after the case had been briefed and scheduled for argument.

The reasons for abandoning our appeal were grounded on the discrepancy which continued to exist between administrative rulings policy as to the distinguishing features of partnerships from corporations and the position which was going to be urged on the Ninth Circuit if the case was presented. As I'm sure you know, the tax court found that two of the four corporate characteristics specified in the 7701 regulations were lacking in the *Larsen* facts. Therefore, partnership status was accorded to the entity in question.

Below, the government argued as an alternative ground, and on appeal as the only ground, that in the event that two of the four corporate characteristics were absent, the court should advert to *Morrissey* and early case law, which examined other criteria to distinguish corporate from partnership status. That initiative, however, was contrary and quite different from the positions taken as a matter of rulings policy by the Revenue Service. It seemed to me inappropriate for the Commissioner's representative in court to take a position which conflicts with the Service's administrative position.

Our duty in *Larsen*, therefore, seemed clear. We had to withdraw the appeal, since the only ground that we felt was available to us when appeal was first approved by the Solicitor General's office was incon-

sistent with the Service's administrative position. There are other examples of this type of situation. I think they all demonstrate, at least in the substantive tax area, that litigating counsel for the government can best contribute to simplicity by ensuring that once an interpretation or a policy has been adopted by the government, within the Treasury Department, within the Internal Revenue Service, or wherever, it should be consistently applied and articulated by the administration.

Now, obviously, government counsel can control only the arguments made to the court by the government. Other views may be urged on the courts by taxpayers. But the various branches of the administration having responsibilities for the interpretation of the tax law should speak as far as possible with one voice.

Of course, this is not always so. I think all of us holding governmental positions now, and all of you who are with us tonight who have held these positions in the past, realize that interagency uniformity of position is sometimes more a goal than reality.

A related function, which is particularly the responsibility of the Tax Division, is to articulate the policy of the administration in criminal tax matters and in some civil tax matters, which are essentially tax procedural matters to be resolved in the district courts and the courts of appeals. There are both problems of complexity and simplicity present in these matters. I am reminded of Jerry Brannon's comment this morning that one way to dampen the incentive to play the tax lottery—which Sidney described so colorfully for us this morning—is to increase penalties so that the disincentive would be great enough to remove the temptation to take a "chance" on the tax lottery.

I submit that this approach to simplicity, a kind of *in terrorem* aid to tax reform, just would not work. Part of the problem, as Sidney was quick to remind us this morning, is that the criminal sanctions of the Code, be they addressed in 7201 to the taxpayer or in 7206 to the taxpayer's counsel or return preparer, require proof beyond a reasonable doubt that the taxpayer acted with criminal intent. The very complexity with which we are concerned makes it difficult to gauge the substantive truth or correctness of a position taken by the taxpayer.

A concern about the tax lottery on the part of all of us who have been in private practice and who have counseled taxpayers, particularly taxpayers who have already been counseled by more aggressive tax planners, is convincing ourselves that there is no room for the so-called return position advocated by the more imaginative and optimistic of our brethren of the tax bar. How can we say, for example, that an exchange that we regard as a purchase is not really a 1031 exchange if

it is so masqueraded. We may apply the O'Byrne "lifted eyebrow test," but our eyebrows may lift at different times and require stronger stimuli.

We have seen examples in the rather well-known criminal prosecutions this year of members of the tax bar in California and in Chicago. The defense in those cases essentially was that the tax counsel involved had been entitled to take aggressive advantage of ambiguities and complexities in the statute. Far from acting illegally or criminally, they argued, they had acted within this substantive law and had correctly advised their clients. What was viewed by the government prosecutor as criminal behavior was regarded by the defendants not only as excusable but as entirely appropriate legal advice.

It seems to me that this kind of confusion and the complexity at so many points in our spectrum of substantive tax problems make reliance on the criminal law to shut down the tax lottery ill-advised.

The two cases to which I refer were prosecuted with at best marginal success. In the first case, all the counts against one attorney were dismissed at the close of the government's case, and the jury found the other attorney not guilty at the close of the trial on the remaining counts.

Post-trial interviews with the jurors, as reported in the press, indicated that the jury was quite confused as to the substantive law. They were looking, one juror said, for a smoking gun, and they didn't find it. Maybe that says something about the utility of juries in tax cases, but I don't think so. I think it says something more about the complexity of the tax law and the clumsiness of trying to resolve complex problems by terrifying the tax lawyer into giving certain, uniformly conservative advice. The other case resulted in acquittal by the jury of one of the two lawyer defendants and conviction of the other.

If we cannot use the deterrent of the criminal tax laws to simplify tax administration, I suggest that the roles of the Department of Justice and the other litigators on the civil side are even more modest in trying to resolve questions of complexity. It seems to me that our duty is to work toward an appreciation of the Treasury's and the Service's administrative problems and to assist them in understanding positions taken and judicial attitudes in cases being litigated.

We've had some experiences since I've been in office where we have been in the midst of defending actions which were contrary to policy judgments then being formulated within the Revenue Service and the Treasury Department, in which neither office fully understood the posi-

tion of the other office. I think that is likely to occur whether we manage to bring all aspects of tax administration within one agency of the government or whether we continue the present system of jurisdiction under separate heads of the administration.

Would we resolve these problems through the establishment of a single tax agency? I suspect not. There would still be units within a single agency which would be performing the kinds of functions Jerry described and which I have tried to describe tonight. The need for teamwork and the need for unification of position is the same, regardless of where one turns and regardless of the way in which the tax official's duties are structured.

Now there's one subject, Dean, that I have not touched on tonight, which you mentioned this morning and which you wrote upon quite eloquently almost 20 years ago now, I guess—the need for a tax court of appeals. Was it that long ago? Forty years ago. Well, perhaps he wrote more eloquently than persuasively. [Laughter] It is a very interesting topic and it is one perhaps which I must leave to later discussion, since my time is more than exhausted. Thank you.

MODERATOR SURREY: Tell everybody that the subject was a single court of tax appeals. The Dean said he wrote on it 40 years ago. I wrote on it 45 years ago. [Laughter] And neither of us got anywhere.

The last member of our panel is the Honorable Stuart Seigel, Chief Counsel for the Internal Revenue Service, who wants to talk about some of the aspects of the Internal Revenue Service with regard to this subject.

MR. STUART SEIGEL: I'd just like to put in focus some of the problems that complexity breeds from the perspective that I now have. As somewhat of a reborn bureaucrat, somebody who has served in government previously and then took a respite for several years in the pleasant environment of private practice, I think the first impression I had when I came back was volume. Everything has increased almost geometrically over the years in volume. For example, the number of lawyers in the Chief Counsel's Office. I had no idea, and that's quite truthful, that that office now has almost 950 lawyers. Tremendous increase.

And it's true that in every aspect of the work that we do, the volume has increased. The volume, I think, is a product of not only the increase in population and increases in economic activity but in some measure increases in complexity. It puts a tremendous burden on the Service, as Commissioner Kurtz pointed out, with limited resources in managing the complex work that it is required to perform. I'd like to talk about

three areas and throw out to you these areas as subjects that I think deserve some consideration in the overall study of simplification of the tax system. You've talked a lot today about simplification from the standpoint of the taxpayer, the tax planner, and the tax preparer. Tonight, we're talking about simplification from the standpoint of the administration of the tax law.

In the three areas I want to mention, there are specific regulations which a number of people have vented some frustrated feelings about during the course of the day. In the area of regulation, the question of volume that I mentioned, the increase, is evident. We have, as you know, since about June, at the urging of some people, some people in this room, published each month a list of all regulation projects pending and the disposition and the activity that occurred during the month, including where the regulations sit.

The number is a large number. There's something like 350 regulations projects that are pending somewhere within the Internal Revenue Service or the Treasury Department or both. But 180 of those projects were borne of the Tax Reform Act of 1976. A law is enacted which is complex and which is responsive presumably to legitimate needs. Taxpayers presumably need some guidance beyond what the legislation itself can prescribe. How is an agency like the Internal Revenue Service or the Treasury Department, given all the responsibilities that they have and the limited resources, supposed to respond by coming out with a quality, well-thought, reasonable, and responsible regulation, when the numbers that they are supposed to handle are in that magnitude, particularly when you think of the necessity for competent people with experience and judgment in that area?

What we have done basically is really very simple. First, we decided which regulations were really needed. And we made some tough decisions, I think, and we decided that of the original list, which had more than 350, almost 450, there were some 70 or 80 that we would dispense with because either the regulation could not in any meaningful way expand upon the statute or its focus and impact was so limited that it would be better to dispense with it than try to come out with a regulation on every conceivable subject.

The next thing we've done is try to order our priorities. Given the magnitude of the job, we have to work on the regulations that are most needed, and so we requested public comment and have received some comment, although I must say quite honestly that the volume of comments was rather insignificant. I think we received 25 comments from members of the Bar or groups giving us their input as to what priorities

we should set in handling regulations. We were asking, in effect, what regulations are most needed. Well, we've done it. We have now set our priorities, and we are working ahead on all the so-called first priority projects. The ones that we have determined, based upon the comments we did receive and our own internal review, are the ones that are most needed.

We're then trying to write the regulations in a fashion that would eliminate repetitive material, material that is obvious from the statute, obvious from the committee report, or somehow doesn't serve a useful function. That's easier to say than to do. But we're trying hard to get the regulations to fill in the missing places, rather than to be a repository of a lot of information that is clear on the face of the statute or from other sources.

And then, of course, we're trying, again within the resources and the procedures available, to improve and to expedite the review procedures of regulations. I don't think the answer is necessarily enough to say that all you need is more people. More people are helpful. But as I pointed out earlier, I think they've got to be the right kind of people; and they are not always easy to get; and they are not always easy to keep on a long-term basis in government service because of the obvious financial and other incentives for people to leave government service. And that is a problem because if you have capable people without sufficient tenure, background, and experience, it can lead to a question as to the quality of the product that is produced.

But that's an area that I think deserves attention. I think it deserves attention of a group such as this. What are the regulations that are really needed? Do you need regulations in every area that you think you do? Everybody expects automatically a regulation to be the next product of a statute. Maybe that should be the case. But I think that whole process, and particularly the kind of input that the Bar itself can produce in helping to formulate regulations, to determine the priorities of regulations, and to help us find out what's needed and what's not needed, is part of the overall problem.

In the area of rulings, the Service devotes a lot of time and attention and a lot of staff power to rulings. When you have limited resources, I think it's fair to raise the questions of what the role of rulings is in the administration of the tax system and whether the allocation of resources that is presently devoted to that function is adequate, inadequate, or, perhaps, too much, because every tax technician who is employed by the Revenue Service who is working on ruling matters could be doing something else if that were not an important and productive role.

I think the questions are important because there are many, many rulings that are issued that are routine, that lawyers pretty well know they really don't need. And that particular type of ruling request puts a strain on the Service's ability to perform its overall function and raises the question of priority. Is that a good place for technical staff power in the Service to be used?

Should there, in effect, be some types of limitations on the ruling process? Should rulings be limited to cases where the answers are not clear? Should there be a more significant requirement that rulings present the issues and present the arguments? There are many ruling requests that come in that the Service handles which no more than ask the question, and, in effect, the Internal Revenue Service, at public expense, is encouraged to do the research and come up with the answer. Maybe there should be a requirement that there be a threshold of a certain type of product that is submitted before the ruling can be acted upon, and if not, that it be returned for some further development.

I'm not suggesting that's appropriate. I'm raising the question because the present procedures do require a significant allocation of resources, and I think the question of the effectiveness of those resources ought to be considered.

Then, there's the question of published rulings. If the Service is to undertake a significant program, which it does, of publishing rulings (which requires a further level of analysis because published rulings obviously go through a much more structured process of review within the Service, the Chief Counsel's Office, and the Treasury) what is the function of a published ruling? Should the Service be issuing published rulings on a broad variety of questions? And if so, is it intended primarily to be a guide for revenue agents? Is it supposed to also be a guide for taxpayers? And if it's a guide for taxpayers, shouldn't they be obliged to follow them? Going back to the tax lottery question, if they don't follow them, should they not be required to disclose that? If they are aware of a ruling and aware of the fact that the position they are taking is contrary to the ruling, should that not be an indication that some disclosure be made on the return?

I think that's important because the resources that are devoted in these areas, as I said before, are significant. I think the role of a published ruling, if the government is to undertake a program, ought to be more clearly defined and its impact more clearly defined, perhaps, than is presently the case.

The last area I'd like to mention, which I also think is deserving of attention in any study of simplification, is the growth in litigation.

Some of the judges of the tax courts who have been here and are here tonight know we have a tax court which is the basic forum for civil litigation in the tax area, particularly for those who are not represented by sophisticated counsel. The tax court now is logging in approximately 12,000 cases a year. I go back to my prior life in the government, and the number used to be 5,000.

They now have a present docket of some 21,000 cases, with an authorized complement of 16 judges and maybe 7 or 8 special trial judges. That presents a lot of problems because we have encouraged, and properly so, taxpayers over the years to be aware of their right to an impartial resolution of disputes; and they are, more and more, taking advantage of recourse to the tax court. At the same time, this, again, puts a strain on the Service's resources. How can the Service handle the disputes that arise out of the audits that are conducted in a manner most designed to settle them without the necessity of litigation? What should the administrative procedures for the resolution of tax disputes be? Should there be a requirement that a taxpayer exhaust his administrative remedy before he can seek recourse through the courts? That is now an ingredient in some of the declaratory judgment procedures that have been enacted in recent years.

As you know, there are now procedures where you can get a declaratory judgment variously in the tax court or the district court or the court of claims in pension cases, in 501(c)(3) cases, and in some of those ruling matters under Section 367. The statute requires that before you can bring your declaratory judgment, you must exhaust your administrative remedy.

Should that concept be broadened and applied in the area of civil tax litigation? Should the courts be burdened with this terrific volume of litigation when taxpayers have not had their case for one reason or another adequately considered at the administrative level?

There is also in the area of litigation the questions of how settlements are conducted and what the responsibility of both the government and the Bar is to the court to promptly and adequately attend to their cases. If the rate of disposals of settled cases were increased, the tax court docket would go down. A good part of those 21,000 cases has been sitting there for a year and, in some cases, two years and, in some more cases, more than that. Sometimes, it's a natural consequence of the case. Other times, it's a consequence of inattention by lawyers on both sides of the fence. If you're talking about the system which is designed to simplify the life of taxpayers, I think we have to address questions such as how taxpayer disputes can be easily resolved or more easily resolved,

how they can feel an opportunity to be part of that problem or dispute resolution system in a meaningful way, and what the appropriate response of lawyers to the court must be to resolve those problems. Thank you very much.

Moderator Surrey: Thank you very much. I, as the Moderator, have not been the restrictor of time because I think we've had four very interesting presentations. Since there were no previous papers, these initial presentations have been necessarily more detailed. I think at this point we should throw the matter open to questions from the floor, and therefore, I'll ask if anyone here wants to present questions to members of the panel.

James Verdier, Washington, D.C.: I have a question for Jerry Kurtz in light of the comments he made about the severe shortage of resources and the very limited number of audits that can realistically be done. As I was looking at the very interesting tax return forms that he sent out to us and the section under credits, I was struck by all the credits we have there and how few people are using any of them. Only 2, 3, or 4 per cent are using each one. I see room there for insulation tax credit and, presumably, an electric car tax credit, both of which are in the pending energy bill.

A lot of these credits are very finely calibrated, narrowly targeted credits—the WIN credits, the former retirement credit is simpler now, the electric car credit, which you can't get for a golf cart, but you can get it for some other kinds of electric cars. If you were asked by Congress, would you really have to say that there is literally no way we can enforce these limitations and that what you're doing when you set up a subsidy program in this way is to say that whoever asks for this credit can get it. If that's the case, a congressman might want to ask himself if this is, in fact, what we want to do. Do we want to provide a subsidy that is essentially available to anybody who asks, and are we kidding ourselves if we think that we can run our subsidies through the tax code and pretend that all of these very refined limitations we are putting on really mean anything?

Mr. Kurtz: Well, I think you're obviously right. There is an expressed preference that was discussed earlier for tax expenditures going through the tax code, rather than the expenditure program. I strongly suspect that one of the reasons is that some 90 per cent of the people who claim the expenditure get it without being questioned, whereas in a direct expenditure program certain requirements have to be met before the money is paid out. We have a system in which the taxpayer does what the goal of the expenditure is, and makes a self-evaluation as

to whether he qualifies to claim it. Then on a random and fairly narrow basis, we audit. There are substantial numbers of errors.

The credit is the newest and most easily identified tax expenditure. I suppose the reason that credits stand apart from some of the other items on the tax return is that they offer very little in the equity complexity trade-off. There's very little equity, and there's a substantial addition to complexity.

In looking at the TCMP data, I find some of it astounding. For example, 70 per cent of the taxpayers claiming medical deductions do it wrong. The average error is 13 per cent of the deduction claimed. Looking at rental income, we find that 57 per cent of the people show it wrong, and the error is 131 per cent of the amount shown.

This theme is repeated for most of the items shown. Of the people claiming deductions for cash contributions, 41 per cent are wrong, and the error is over 16 per cent. Since these errors are determined as a result of audits, they are conservative. Who knows what we aren't finding? So when there is talk about adding complexity in order to get equity, the very fine lines drawn are just not fine enough. With the complexity of adding deductions comes substantial amounts of error that we do find and of overclaiming that we don't find.

One way to think about simplification is to look at a tax return very carefully. In a recent hearing before the Oversight Subcommittee of the House Ways and Means Committee, it was suggested that before Congress does anything, it ought to get a draft of what the form will look like and that might be a very good way to judge complexity and simplification. Frequently, things that sound very simple in theory result in complex forms which produce very high error rates both computationally and in terms of recordkeeping.

Moderator Surrey: Would that, Commissioner, help, for example, on the credit question? In other words, would it be enough just to show Congress that there's one more line on the return with respect to a suggested credit, or would you have to do more and show them a page of instructions or so? I'm curious about whether one line on the return would do it.

Mr. Kurtz: No, I don't think one line on the return is a convincing argument, but we now have 60, and they are made up of 60 individual lines. I don't know where the last straw comes in, but it's somewhere in those lines, the instructions, and in the errors and the deviations from what may have been regarded as a perfect statute. The concept is one thing; the way it is actually reflected on a return by taxpayers is something quite different.

Mr. Griswold: A separate form is often hard to get with respect to a good many of these credits and other things.

Mr. Kurtz: I might say, Dean Griswold, I asked to see, in conjunction with the hearing we were having, a Form 1040 with all the schedules that could be attached to it if one filled out every line of the return, and it was a stack at least half an inch thick. The 1040, in all its glory, is an enormously complicated document if you take all the schedules into account.

Mr. Verdier: My guess is that Congress would be quite struck by those illustrations of complexity. I think people are starting to appreciate that, but I think they'd also be struck almost as much by the notion that what they're doing under all of these new credits is essentially laying out stump money. People can buy and walk by the stump and pick up the money. And that's all they're doing. I don't quite think people have gotten that into their heads yet.

Mr. Kurtz: Well, I think it's something that ought to be emphasized. Complexity is not the end of the question by any means. The fact that something is complicated does not in itself mean that it should not become a part of our tax law. But it certainly is a substantial weight to be put on the balance against the equity that's to be achieved, and I don't think it is weighed. This can be seen not only if you look at what Congress has done in recent years in terms of complexity but in the other ways in which it deals with the tax law. For example, take the energy credit. Here we are in January, the filing season is under way and we don't know whether there's to be a credit or not. As a result, we don't know what's going to happen, and it makes planning very difficult.

People may not file their returns until later, in which case the schedule of our 50,000 temporary employees who come in to process the returns is all messed up, since the returns won't come in when they're supposed to. If the credit is enacted on a retroactive basis, we may have seven or eight million refund claims filed later on. Other taxpayers will file claiming what they guess is the credit, in which case we may have a substantial problem of another kind. This is not the first year that this type of situation has happened. It's becoming a repetitive process and creates just enormous technical difficulties. For example, we will get an estimated seven or eight million phone calls during this filing season dealing with the home insulation credit. When you consider that we normally get something approximating 25 million phone calls, that's a substantial extra load to handle.

Sheldon Cohen, Washington, D.C.: Jerry or Stu, we used to get, we were lucky I guess, an agreement from Mr. Mills, who unfortunately is no longer with us, on that filing problem. That is, after September 30, no more legislation effective this year. I want to ask a question. We'll all ask a question that is our own pet peeve, of course, so you'll forgive me. I put to the American Bar Association Coordinating Committee, 12, 13 years ago, an idea that Stu just threw out. I don't know how many people are now in the technical organization. At that time, there were about 700, and I've forgotten the number of rulings, but you grind out X number and, as always, we were short. You are complaining that we are not timely, and I will agree, I complain too.

Suppose we decided together to have a no-rulings area because we don't know what the policy is or we aren't going to give license to tax avoidance. Let us just decide there are certain areas of the law either that are so well developed that no further rulings appear to be necessary except in unusual circumstances or that are not of such consequence that people would not be willing to fly by opinion. And that would exclude, of course, rulings devoted to the reorganization of a public company or something that has such mass consequences. Even if the answer is routine, it probably should be given nevertheless.

But it would cut out the hundreds and, perhaps, thousands, John Withers can perhaps tell us how many, of just plain insurance rulings. I put in, just like everybody else, because Gresham's Law requires me to do it. If I don't, someone else will. But have you tried or have you thought about the savings? I mean, how many hundred men and what would they be devoted to? Could you put out more regulations? Would they be used on this, that, or the other thing? Is this the way we ought to run the system, grinding out an insurance policy for Sheldon Cohen's clients because they can get it and the price is right?

Mr. Seigel: I don't know what the numbers are exactly in terms of how many people could be affected. I presume it would depend, in part, upon how the ruling policy, if modified, were modified. I'm certain that the technicians in that area could certainly be used in other areas of the service, such as in the audit area, particularly in the more complex cases and in training agents and things of that nature. But I think the important question really is whether the ruling process, as it is presently structured, is serving not only useful needs but some perhaps not useful needs and whether the system and, particularly, how it relates to published rulings, contributes to complexity. I think they're questions that have to be thought through. I have frankly not

thought them through. I've thought of some of the questions as I've sat and watched some of the problems that arise.

You also have to remember that the private ruling system itself can be productive of problems. Some of the problems that Carr talks about, where there has been some divergence on occasion or even more than on occasion between litigating policy and the technical policy, sometimes occur because of private ruling letters that have been issued that have not been given the kind of review, for one reason or another given the volume of work that is done, that they probably ought to have been.

So, I just throw that out because I think there is a question of service to the taxpayer that the ruling process serves which probably ought to be preserved. But the question is to what extent and what burden does that put on the service now, and how does it affect the question of simplification of administration of the tax law?

Mr. Kurtz: I'll just add to that. Certainly, the technical advice procedure is one that's required administratively to run the Service. That's where agents get answers to difficult questions that they run into during audits. But as to the taxpayer's request for a ruling, they are, as you say, insurance policies which we give taxpayers. We don't give adverse rulings to taxpayers because they withdraw the request before we give it. There are those within the Service, including some in very substantial positions, who say we should not give rulings at all. We ought to be devoting those resources to the problems of lower income taxpayers who are less able to help themselves than those who are able to hire expensive lawyers to come and ask for a ruling. If taxpayers hire an expensive lawyer, let the expensive lawyer answer the question. Why should the Service do it?

I'm not saying I agree with that. I'm saying that this is a view which is held by people, by some with long experience, and I think it's a view that's worth considering—whether the Service ought to be devoting significant resources to the rulings activity.

Martin Ginsburg, Currently California: In 1975, the New York State Bar Association Tax Section had occasion to obtain from the tax court a great deal of material that it had on case load, decided cases against filings, and so on. As I recall, it showed that there was something like a little over 1,000 decided cases in the most recently completed year, as against filings of then I think about 10,000. So they were running fairly level at a 90 per cent settlement over a period of years, 10 per cent decided cases.

Sometime in the last 24 hours, I think I heard a statistic that said that the tax court is now deciding 25 per cent of the cases. If that is, in fact, true, I wonder if any of you gentlemen, perhaps Stuart particularly, have any views on what happened?

Mr. Seigel: Well, I think the current settlement rate, at least statistics I saw, was 73 per cent. That means 27 per cent of the cases are going to the court for decision. What has happened? That's an interesting question. We're trying to find some of the answers to that because that compounds the problem of the increased volume obviously. If you have an increasing base of litigation and an increasing percentage of it is not settled, well then the burden really is becoming very significant.

I think the answer, in part, is due to the complexity of the law to some extent. I think there are many more areas where there are unresolved, technical questions that are more difficult to settle. I think also part of it in the smaller cases is partially attitudinal. Smaller taxpayers feel that they have not gotten a fair shake from the Service and want to have an impartial judge decide their case.

Now, we've seen that demonstrated in some cases where there have been programs to offer free legal assistance by various bar groups to taxpayers who represent themselves *pro se* in the tax court, particularly in the smaller cases, and a good number of them do not want the lawyer. They want to go before a judge and argue their case. To the extent that that's a problem, I'm not sure there's much we can do other than somehow try to improve our administrative procedures to get these people in because we do find that, of the small taxpayers who do come in ultimately, we settle a tremendous number of cases.

So, it's a combination, I think, of the attitude and, to some degree, the complexity. Because the cases are more difficult, there's less precedent, particularly with the flood of litigation we've had in the last 10 or 12 years, and I think, to some extent, that as well affects it.

Another part of it, in part, I think, relates to the Bar's approach, our approach, to settlement. That's more intangible. But I do think it's important that everybody realize that things ought to be considered in certain respects that might improve the ability of adversaries to come together and reach a meaningful agreement in these cases.

Moderator Surrey: Dean Griswold, did you want to say something?

Dean Griswold: I would like to make an observation in support of what I take to be Jerry Kurtz's position with respect to rulings. He said that there was strong feeling within the Service that rulings shouldn't be given. I think it would be a great mistake to terminate

a fairly widespread ruling policy, though within limits. It seems to me that it is a service which ought to be performed by an administrative agency under a system of self-assessment without which the whole thing will collapse.

Moreover, it does not require as much net of administration services as it would at first appear because when you have these rulings and they are attached to the return, nothing has to be done in connection with the audit of the return. However, if you couldn't get the ruling and the returns were filed, hundreds of these things would have to go to conference, would have to be dealt with, would have to go upstairs for consideration, and the amount of time spent might be very close to what it is now.

Moreover, there is the problem that was referred to earlier—just finding the returns in the case of corporate reorganizations. I'm not talking about U.S. Steel or AT&T, but small businesses and what not in which there may be 3,000, 5,000, 10,000 shareholders. If it turns out that the lawyer gave advice that the Treasury ultimately doesn't agree with, all of those would have to be dug out and deficiency notices sent to them and so on. By having a ruling in advance, a great mass of administrative activity is eliminated, and I certainly hope that in the interest of simplicity, what we're here for, that the Treasury will not reduce its ruling policy, except within certain types of cases where perhaps it is not necessary.

Mr. Kurtz: Let me clarify the record if I left it unclear. My view accords with yours, that we should continue issued rulings. All I was suggesting was that the other view is held by some.

Mr. Griswold: And I was trying to back you up in resisting that view.

Mr. Graetz, California: This question about settling cases. One of the questions that has occurred to me, and I've never had the opportunity to put it to the government this way, and I would be interested in the response of both of the IRS representatives and the Justice Department, concerns the recent decision by the Supreme Court on the standing issue involving challenges by public interest taxpayers, people without a direct stake in tax consequences. It seems to me that this has resulted in a situation in which if the IRS takes a position adverse to the taxpayer, there is the likelihood and the probability of a traditional review. And if the IRS takes a position favorable to the taxpayer, there is no opportunity for the judiciary to review the administrative determination because the taxpayer who has standing will not challenge the IRS.

There are two possibilities this could have in terms of the administration of the law and the willingness to take positions. One is that it could make the IRS more adamant about taking tougher positions on the theory that the courts will reverse them if they are wrong. And that's the only occasion where the courts will have an opportunity to consider the issue. On the other hand, it can make the IRS more lenient, in some cases, because if they're wrong nobody can second guess them unless somebody goes to Congress. The Justice Department has always taken the position, to my knowledge, and the IRS has always taken the position, contrary to standing by people with no direct stake in the litigation. The result has been the situation where you essentially have a judicial review of administrative determinations only where they're tough. I wonder whether there's any impact on administration of the law or litigation policy, in terms of maybe even the settlement number that Marty points out, that anyone perceives in this new context.

MR. FERGUSON: Well, I will respond first. It is true that the Department of Justice and the Revenue Service traditionally have taken the view and the position in Court that parties not directly concerned with the tax liability in question do not have standing to litigate a third party tax liability. The courts, including the Supreme Court, have for the most part been sympathetic to this position, I think largely because of considerations of the administrative and supervisory limitations on the availability of access to the courts.

The potential for promiscuous litigation if the rule were to the contrary is very serious given the crushing number of tax controversies that face the courts already. There are bills in Congress that would effectively reverse some of the more recent standing cases, including the latest TAA loss in the Court of Appeals. These bills would broaden standing without much in the way of restrictions. At least two third parties, as well as the Department of Justice, have taken a negative view toward that kind of litigation and that proposed legislation.

My own feeling is that there may be some room for broadening access to the courts by nontaxpayers in situations such as you described. I would be very interested in exploring ways in which we could identify cases, perhaps by kinds of rulings or categories of potential litigants, in which parties other than the taxpayer directly involved ought to be given standing. Those are very complex and sensitive problems, however, because it is difficult to grant standing to some nontaxpayers and not others: The situation is further complicated by the confidentiality of taxpayer information which might be involved.

I suppose if we were to broaden standing, it would have to involve an almost hypothetical ruling type of fact statement that would not intrude upon the taxpayer's identity or specific taxpayer information. Now, can you imagine having to litigate a case within the four corners of the hypothetical facts stated in a published ruling, which may be, and, in fact, normally are, incomplete? You would want to know more. You would want to know much more. You would pursue additional information that you felt to be critical to a successful resolution of the case. And you would have to consider the extent to which you wanted to amend Section 6103 simultaneously with a consideration of the kinds of cases in which standing properly should be broadened.

Moderator Surrey: Thank you. I imagine you've given Tom Field some encouragement. He ought to feel better after that answer I think.

James Lewis, New York: I would like to chide the Commissioner on his semantics, and I do it in all friendship. But when he says 30 per cent of the taxpayers were wrong, he means 30 per cent accepted the adjustment because they didn't know any better or because it wasn't worth fighting. If one of Stuart Seigel's people says to me, "Well, you're litigating over $100,000 and we'll take $8,000, it will cost you more than that to try the case," I don't give up because the taxpayer was wrong. I give up because I understand what he's saying. When the computer tells me that one of my returns is wrong, I know better than the computer, and I do something about it. I wonder how many of those taxpayers that you say were wrong, were wrong, and in how many cases it was the agent that was turning the matter the other way; and the taxpayer just didn't have guts or courage or money or knowledge enough to do something about it.

Mr. Kurtz: The figures that I was referring to were those from TCMP audits, Jim, and I can't certify to them. Those audits are supposed to be done particularly carefully with a view to determining the accurate tax on the return. They are done differently than normal audits. Items are not supposed to be settled, but followed through to the end and then proven to be right.

So, while I can't certify that this was done on each audit, I suspect that the figures are reasonably accurate and are not the result of the taxpayer giving up in most cases. And, I might say, we are finding error rates that are appalling.

Bernard Wolfman, Massachusetts: I would like to go back, just for a second, to the question that Mike Graetz and Carr Ferguson were dis-

cussing—the question of standings in cases in which the plaintiff is not an adversely affected taxpayer directly. I would just like to encourage the Department of Justice to take an initiative in preparing a bill that might deal with the question, rather than just reacting against or with respect to bills that are being proposed by lots of others.

There is a division in the Department of Justice, headed by Dan Meador, called the Office for the Improvement of the Administration of Justice.

I received a copy of a bill and a proposal that his office has prepared with respect to a very difficult, knotty problem involving class actions; and he's come up with a very imaginative approach to two different types of class actions that were heretofore thought to present intractable problems. The reason I suggest that something like that be done is that I, and a few others in here, including somebody on the platform, were involved in a case in which we had questionable standing attacking the validity of the ADR regulation. We, as plaintiffs, represented a broad group of the public that felt that that regulation was illegally giving away revenue.

The issue never got resolved because the government ultimately did go to Congress to validate part of the regulation, and the other part was withdrawn. That's the kind of issue which hopefully will rarely occur. One of the reasons we don't have broad standing is that we assume that the government will protect the public interest and it's accountable politically. But there are times when the significant segment thinks that the issue is pressing, that there's a lot involved, and that fairness requires objective resolutions.

And I would think that in Dan Meador's group, your group Carr, there could be a way to draft a narrow, tight, but effective statute to provide some means of testing out the validity of regulations when enough people think that you're giving money away.

MR. FERGUSON: Well, I agree. That's why I take a view somewhat different from, perhaps, most of my current colleagues. I think there is room for this. One other question, I suppose, which ought to be settled by any such legislation, Bernie, is whether the objective determiner properly is a court or whether it ought to be determined by Congress. Stu and I recently spent some time on a matter in which we concluded that, while there was a very serious question about standing, there was also a very serious question about the position taken by the Service and the way in which the law was being interpreted. As a result, a change was made in the way a particular statute was being administered.

So there may sometimes be a hearing at one level within the administration where this kind of matter can be thrashed out. But I agree with you that in, perhaps, certain narrowly defined kinds of cases, certain kinds of plaintiffs should have judicial access. We have been working with Dan Meador's office and also with representatives of the Service to explore avenues for a limited kind of taxpayer's or nontaxpayer's standing for tax litigation to see if we can come up with that kind of bill.

Walter Blum, Chicago: I'm not sure that the topic that we've been talking about is very close to the theme of the simplification, and I'd like to move us back more to the mainstream of simplification. And in that connection, I wish to address a question to Jerry Kurtz. Jerry, let's assume that Congress decided not to give you any more resources. Let's assume Congress said that it wanted to collect about as much money as is now being collected through the income tax system, but was perfectly willing to entertain from you proposals for changing things around in such a way as to improve your ability to manage complexity. By that I mean Congress was willing to change the statute of limitations or, perhaps, your investigative powers or the penalties that are available to you, various things of that kind. What kind of proposals would you be willing to submit to Congress?

Mr. Kurtz: Well, I almost hoped they wouldn't ask me that right now. Frankly, there's a great deal we don't know, and among those things we don't know are such unimportant questions as why people pay their tax. We don't know, for example, and this goes directly to how we ought to use budget resources, whether voluntary compliance is better with more taxpayer service and less audit or with less service and more audit. Now that's a very fundamental question.

Does someone who tries to call us on the telephone and can't get through after six calls figure I'll deduct it anyhow? We don't know the extent to which that goes on. We don't know, for example, in allocating audit resources among various taxpayer classes, how best to encourage compliance. We allocate now basically starting out with marginal yield per dollar spent and then adjust a little bit into the noncompliant classes. We know that produces a high rate of return on audit, but we don't know its effect on voluntary compliance, which is certainly the biggest part of our tax collection. You know, we collected $358 billion voluntarily and $5 billion on audit in fiscal 1977. If we pick up more on audit, could we lose even more in voluntary compliance?

We don't know the answer to that question. Maybe we ought to be spending our funds on the least compliant classes, who, it turns out, are the most expensive and least productive to audit because the most

potential deficiencies are in the nonaudited group within those classes. Now we don't know what the relative importance is of civil and criminal enforcement efforts in gaining compliance. We don't know whether a businessman is more likely to comply if a businessman goes to jail or if Al Capone goes to jail. These are very fundamental questions debated within the Service for years and years and about which the Service has enormous amounts of experience and intuition but no real knowledge.

So I don't know quite how to answer that question. I can give little answers, but if you're asking very fundamental questions, these are questions to which we do not have the answers. We are drafting study proposals to try and find out more. There's a group that Sheldon is chairing that is looking into criminal sanctions. The group has been trying to find some answers for 18 months, and hopefully, if you ask me that question two or three years from now, we'll be closer to answers. I'm forever optimistic. We may never have answers, and therefore we will always move incrementally from where we are now, not being sure of what the right direction is. But these are very difficult questions. I think it is not well understood that tax administration turns out to be an art, not a science, in a sense that we're answering where we have unquantifiable knowledge.

Moderator Surrey: I don't think that we were diverting time from simplification in discussing the standing issue because some may feel that the more generalized statute is to be written with delegation to the Treasury to issue regulations with more power. Some may feel that it should be accompanied by a statute permitting standing of the type that Mike Graetz has indicated. So the issues are related to simplification, I think.

Hugh Calkins: I would like to ask Jerry Kurtz if he would comment on the role of revenue agent discretion in the management of complexity. I have in mind particularly business tax returns which are regularly audited, particularly the business tax returns of smaller businesses. We have a panel tomorrow devoted to that subject, which will address itself to whether the present system is satisfactory from the standpoint of taxpayers. It will suggest that the present system works in fact in a fashion in which complex provisions in the Code and Treasury Regulations dealing with depreciation in inventory and so on are applied to small business without a great many disputes being raised because revenue agents don't apply them literally.

Mr. Kurtz: What do you mean by small business?

Mr. Calkins: A much debated topic and for this purpose I'll say anything with less than $500,000 of sales.

Mr. Kurtz: We have a category we call small business which is under $10,000 AGI.

Mr. Calkins: I think the principle is the same. I have in mind those businesses big enough to attract the attention of your auditors and small enough that in practice there is a great deal of discretion exercised in not applying provisions of the code and regulations literally.

Mr. Kurtz: I can't answer that in any really well-informed way, Hugh, because I don't have enough knowledge of what revenue agents examining businesses with sales of up to $500,000 actually do. Whatever impressions I would give you would be impressions that I have from practice rather than from within the Service. My perspective is changed. Five hundred thousand dollars used to be small. It's not that small any more. It's rather large as taxpayers go. But with smaller taxpayers, I think agents tend to audit those returns rather quickly and therefore do not get into complicated disputes.

Agents do use that kind of discretion, I think quite properly, in auditing a return and don't audit a $50,000 inventory the way they would a $50 million inventory.

Mr. Calkins: Let me put the issue as it appears to me to you. It seems to me there are two ways one can look at that situation. One is to say that the present situation from the Internal Revenue Service standpoint is all right and is to be preferred to trying to complicate the Internal Revenue Code by provisions that are specific to small business, which could be literally applied to these businesses without creating unreasonable complexity in their operation. That would be one view.

The other view would say that the present situation isn't very satisfactory because it creates too much opportunity for inconsistent treatment among districts, too much discretion for revenue agents, too much difficulty in applying negligence penalties, too much of a tendency to teach taxpayers that if a law isn't applied precisely in one area, then it won't be applied precisely in other areas. Do you have any feel between those two positions?

Mr. Kurtz: Yes, I can give you my personal reaction to that. I think it might well be useful to have simpler rules for smaller taxpayers. The problem is that when we've talked to small business groups which consistently advocate that position, it is always advocated in a context which significantly reduces the taxes for small taxpayers. That is, don't bother with inventories, period. I don't think that's an answer. Or allow all

assets to be written off over five years. Well, that's simple, but I don't think it's an equitable solution. It may be that there are simplifications for small taxpayers. However, there have to be, it seems to me as a matter of equity, middle-of-the-road solutions that in the aggregate achieve roughly the same results that the right solution would achieve and that do not merely accelerate deductions and defer income as a way toward simplification.

Moderator Surrey: The hour is late, and I just want to put two questions, which the speakers didn't get to, but I think they are rather important, and I think they can give their answers promptly. One, which Ward Hussey did have in his outline, what would happen if a future Congress were to add a section stating, in effect, that provisions of the Code were to be applied to the substance of transactions, rather than to their form? How many provisions designed to prevent avoidance and to prevent narrow, bureaucratic interpretations could be omitted from the statute because of the effects of this new section? Ward, do you really think that is different from today, and it would have the consequences you indicate?

Mr. Hussey: Yes, I do. I think that there are an awful lot of provisions in the Code that go to this question. One instance would be provisions dealing with step transactions. In drafting sessions, we worry about this question, and we worry about whether taxpayers and tax administrators will look strictly at the form of the transaction, rather than at the overall effect of the transaction.

Moderator Surrey: The other question was Carr Ferguson, who will tell us his position on the single court of tax appeals. [Laughter]

Mr. Ferguson: I feel like a stalking-horse on this one. I hoped you all would give a view on this question. I think of the inverted pyramid that Dean Griswold reminds us he described 40 years ago, whose basis is the single tax court, so conscientiously concerned with uniformity that it's hesitant to urge an increase in its membership beyond 16, despite a backbreaking load of litigation, and whose appellate apex is ten circuits plus the District of Columbia circuit. My own feeling is that a centralization of appellate jurisdiction short of the Supreme Court is very desirable. I'm not as concerned about the relative handful of actual conflicts that exist among the circuits as I am about a much greater number of areas in which there are different approaches in attitude. Indeed, frequently within the same circuit, different panels may produce different results.

Now, I would think that a central, unified court of appeals has merit, whether its jurisdiction is limited exclusively to tax matters or not,

whether appeal is a matter of right or a *certiorari* procedure, and indeed whether such a court is inserted immediately above the trial court level or is inserted above the current appellate court level, although I must say I favor the former. Some kind of centralization short of the Supreme Court is long overdue. I think that's a much more serious problem than the companion issue of whether the litigation in the first instance should be restricted to the tax court or the district courts or whether tax jurisdiction of the court of claims should be abolished, as is sometimes suggested.

If it is possible to construct a single appellate court to resolve tax appeals, I think we will have taken a very significant step toward simplicity in the field of litigation.

Moderator Surrey: Thank you very much. Dean, did you want to comment?

Mr. Griswold: No, I just want to record my dissent from Bernie Wolfman and Carr Ferguson with respect to standing. I think it would be very unfortunate to have a system where anybody who thought the Treasury had made a mistake someplace could go into court. The Treasury is the agency which is assigned the responsibility of administering the tax laws. If they do wrong to a citizen, he ought to have a chance to review in court, and he does have. But if they decide in favor of a citizen, he then should not have to fight anybody around who thinks it would be a good idea if he had lost. And I'm particularly concerned because of the fact that these groups who get upset at something that has happened don't have any responsibility in the area; whereas the Treasury does have the responsibility.

I think the groups ought to have a place where they can speak, and that's Congress. They can go to Congress, that doesn't necessarily mean finding a Congressman, they can get to the Joint Committee, and if they have something to say, they can get a hearing. That's what happened with respect to the ADR, but I think it would be very nearly chaos, not to mention simply wrong organization of the government, to have a system under which any individual could oppose any action which the Treasury takes because they just don't happen to agree with it.

Mr. Ferguson: I think Bernie and I are both sensitive to those problems.

Moderator Surrey: I do want to thank the panel for their participation. I think it's been a unique opportunity to hear four high officials of government discuss these matters so frankly. [Applause]

5

Simplification for Business Taxpayers

Session: Friday Morning, January 6, 1978

Moderators:	Hugh Calkins Max E. Meyer
Panelists:	Howard G. Krane Meade Emory J. Fred Kubik John R. Lindquist John C. O'Byrne William P. Streng Alvin C. Warren
Commentators:	Rick Koffey Charles E. McLure, Jr.

This morning's large panel was intended to deal with representative problems affecting business taxpayers. The first portion of the presentation was devoted to business taxpayers generally and was chaired by Max Meyer; the second portion was devoted to the problems of small business and was chaired by Hugh Calkins.

* Hugh Calkins is a member of Jones, Day, Reavis & Pogue, Cleveland, Ohio.

Max E. Meyer is a member of Lord, Bissel & Brook, Chicago, Illinois.

Howard G. Krane is a member of Kirkland & Ellis, Chicago, Illinois.

Meade Emory is a member of LeSourd, Patten, Fleming, Hartung & Emory, Seattle, Washington, and was a Visiting Professor of Law at the Southern Methodist University School of Law, Dallas, Texas.

J. Fred Kubik is a certified public accountant with F. B. Kubik & Co., Wichita, Kansas.

John R. Lindquist is a member of McDermott, Will & Emery, Chicago, Illinois.

John C. O'Byrne is a Professor of Law at the University of Georgia School of Law, Athens, Georgia.

William P. Streng is a Professor of Law at the Southern Methodist University School of Law, Dallas, Texas, and is counsel to Haynes & Boone, Dallas, Texas.

Alvin C. Warren is a Professor of Law at the University of Pennsylvania Law School, Philadelphia, Pennsylvania.

Rick Koffey is in the Office of the General Counsel of the United States Treasury Department.

Charles E. McLure, Jr. is the Executive Director of Research of the National Bureau of Economic Research, Cambridge, Massachusetts.

Howard G. Krane discussed depreciation and the investment credit.[1] Depreciation is a structural item, while the investment credit is a tax expenditure item; however, both depend on useful life estimation and are accompanied by recapture provisions.

The Asset Depreciation Range (ADR) has wrought substantial complexity in and of itself. Less than 1 per cent of businesses in the country with assets not exceeding $500,000 use ADR, however. Most of the large corporations use ADR for determining depreciation, although few use ADR with respect to repairs.

There are some relatively easy ways to simplify depreciation. It could be replaced by an immediate write-off; or, the deduction could be postponed until the asset would be sold, exchanged, or scrapped. Among the intermediate positions would be the establishment of categories of useful lives based not on different businesses, as under the ADR rules, but solely upon the nature of the asset. One could select broad categories—say, short, medium, and long life—and allow only a single method of depreciation within each category. One could forget about salvage value and provide for total recapture.

The investment credit has raised special problems. Entire industries have grown up because of the investment credit. If the investment credit were refundable, it could be administered by a single credit with recapture provisions when properties were sold within the period for maximum allowances. The need for useful life determinations would be eliminated. Finally, the credit could be available for structural and building components used in connection with manufacturing activities. In part because of definitional problems, it would not be wise to establish special rules for small businesses.

Professor Alvin C. Warren discussed proposals for the integration of corporate and individual income taxes.[2] Professor Warren cited the many integration plans that have been formulated. The degree of simplification that would result would depend upon the nature of the particular plan. Any integration plan, however, would require some very sophisticated mechanisms that would be likely to add new complexity to the Code. The treatment of corporate preferences is an example of such a problem. The issue is whether to transmit the preference to the shareholders. The simplest solution would be to base the gross-up on actual taxes paid, to prohibit the pass-through of preferences, and to stack taxable income first. The plan could be easily administered. The shareholder would report dividends in the usual

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[1] Mr. Krane's Conference Paper is reproduced in Appendix II, pp. 295-311.

[2] Professor Warren's Conference Paper is reproduced in Appendix II, pp. 313–39.

way and would take a credit based upon taxes actually paid by the corporation, a figure that would be reported to him. Once in place, the system would be only marginally more complex than the present withholding system on wages. Although it would be a complex system, as an administrative matter it would be relatively simple to run.

Professor Charles E. McLure, Jr. thought that the problem was substantially more complex. He agreed, however, that once a plan was adopted, it could probably be implemented. The system is not neutral, however, because it forces a complete corporate payout of taxable preference income and rewards retention of income.

Rick Koffey noted that there is no necessary correlation between the complexity of a concept and the complexity of a statute that implements the concept. Accordingly, he agreed with some of Professor Warren's conclusions. Many lawyers might have no need to understand fully the conceptual basis for a statutory provision. He cited the provisions of Subchapter S, which stack taxable income first, stack preferences second, and wash preferences out when they are distributed.

John Lindquist discussed simplification of ERISA.[3] He pointed out that the tax expenditure involved in private retirement plans is a permanent fixture. The ERISA system reaffirmed that fact and encouraged expansion and increased equity. Moreover, there is a renewed desire to protect the interests of employees. Simplification could be attained by removing the principal elements of ERISA regulation from the Internal Revenue Code. He suggested the elimination of discretionary authority on the part of the Departments of Labor and the Treasury to approve transactions between an employee trust and certain interested parties. He favored a return to the establishment of statutory standards. He conceded that the removal of regulation provisions to another statute and another agency would not necessarily advance overall societal concern for simplicity of the law, as distinguished from the tax law. One special problem inheres in the definition of the defined contribution plan and the defined benefit plan. He favored the extension of the substitution of percentage for collar limits and the elimination of the qualified joint and survivor annuity concept.

Hugh Calkins then assumed the chairmanship of the session. The subsequent discussion was directed to small businesses. Mr. Calkins noted that there was an immediate definitional problem concerning what constitutes a small business.

Professor William P. Streng provided a general introduction to the topic.[4] He noted that substantial activities had occurred with respect

[3] Mr. Lindquist's Conference Paper is reproduced in Appendix II, pp. 341–53.
[4] Professor Streng's Conference Paper is reproduced in Appendix II, pp. 355–99.

to the posture of small businesses. Complexity creates great difficulties for small businesses by requiring time and energy to be devoted to tax planning and compliance. Additional problems arise from the multiplicity of taxing jurisdictions. There are further burdens of reporting and paying payroll taxes and estimated taxes. Moreover, in the area of taxation for small businessmen, the educational opportunities are modest.

Professor Streng suggested that the real problem of complexity is more procedural than substantive. The problems relate to return filing and recordkeeping requirements. Discussion at Internal Revenue Service Small Business Advisory Committee meetings has been devoted to difficulties in compliance in obtaining adequate information during the audit process. The real problem might be focused more on the tax return preparer, the company accountant, and the Internal Revenue Service, rather than on the shoulders of the tax lawyer. Also there is a question as to whether data requested is necessary, and whether motion might be requested on a form which is more consistent with small business recordkeeping and financial accounting procedures.

J. Fred Kubik discussed small business problems from the perspective of the accountant.[5] He viewed the primary task as the creation of a system that was simple enough for the average taxpayer and also sufficiently simple to allow the government to enforce the law in a rational way.

One element of simplification easily available would be the creation of published indexes for LIFO users that would indicate the dollar value for LIFO inventory purposes. The suggestion was included in the tax legislative recommendations of the American Institute of Certified Public Accountants Tax Division. The availability of LIFO inventory is necessary for small businesses to combat the effects of an inflationary period. Moreover, a provision for the write-down of subnormal goods should be adopted.

Mr. Kubik indicated that many small businesses are using inventory methods that are not proper. One could propose the complete elimination of inventories to encourage small business, but this might encourage poor business practices. There is, however, a continuing question of whether an expenditure should be capitalized or deducted. Mr. Kubik saw no solution to the recordkeeping problem.

Professor John C. O'Byrne discussed problems of agricultural taxpayers.[6] After limiting his observations to middle-income taxpayers and

[5] Mr. Kubik's Conference Paper is reproduced in Appendix II, pp. 401–18.

[6] Professor O'Byrne's Conference Paper is reproduced in Appendix II, pp. 419–38.

counsel who are not tax specialists, he made some pragmatic suggestions for simplicity. One would be to accept the potential for shifting income where cash method accounting is followed. Further, he suggested the modification of administrative attitudes toward taxpayers, preparers, and advisors. He would recommend some relaxation of the timely election rules to avoid the imposition of an overly large penalty from slight oversights. Local procedures should be examined to see whether they encourage compliance or whether they aggravate preparers and taxpayers. Toleration guidelines could be established that would reduce necessary litigation over small amounts of money.

Professor O'Byrne pointed out that guidelines have generally served useful purposes and have been followed by taxpayers. Substantive guidelines are needed for Service positions. Whether certain sales income should be characterized as capital gains or ordinary income should be clear. The Service appears to be changing its position with respect to condemnations and tax-free exchanges. If there is to be a change, taxpayers should be warned in advance.

Effort should be made to establish some across-the-board simplification. The Subchapter S rules should be reconsidered. Sale of a residence by a taxpayer over age sixty-five should be reexamined. There has, however, been some progress. Farm development has been substantial. There are improved tax tables and publications.

Meade Emory commented from the perspective of the Internal Revenue Service.[7] Mr. Emory indicated that one of the reasons that the Service cannot take more meaningful steps to promote simplification is that Congress enacts increasingly complex legislation. The Service should play a greater role in the development of tax legislation during the enactment process to assure that administrative concerns are raised. Although there is substantial coordination between the Service and the Treasury, events move rather quickly during the markup process and the absence of Service input can result in a failure to perceive some problems. One suggestion would be to prepare forms that would carry out the legislative provisions pending before the Committee. This would give direct evidence of the degree of complexity that would evolve from the enactment of any particular proposal.

A further problem is that tax legislation is being enacted later in the calendar year so that adequate forms cannot be devised to implement changes. Form 1040 for 1977 left two blank lines because of delays over the energy bill. The legislative process further impedes simplification efforts when substantive issues are interjected into non-

[7] Mr. Emory's Conference Paper is reproduced in Appendix II, pp. 439–61.

substantive legislation. For example, the Technical Corrections Act of 1977 has been used as a vehicle to fight the carryover basis squabble. Congress and those that petition Congress will have to become more responsible and concerned about the interests of tax administration if improvements are to be made. The accelerating pace of legislative change, moreover, is imposing an increasingly heavy burden on the tax system.

There are proposals for simplification in administrative practices. It might be possible to design forms with particular groups of taxpayers in mind. The object would be to avoid compelling a taxpayer to wade through material on forms that did not relate to that particular taxpayer. Many partnerships may not, for example, really be required to file a balance sheet. Simplified forms for ADR users might be developed, particularly for small businesses. Some material is accumulated primarily for statistical purposes, rather than to assure compliance by the reporting taxpayer with his obligations under the tax law.

The discussion was then opened to all the conferees. One conferee expressed disagreement over the suggestion that forms preparers be available to congressmen. He was concerned that Congressmen might fail to perceive the degree of complexity inherent in their proposals when they can see those proposals set forth on a form. A tendency might be to regard individual increases in the length of the form as modest and of no significance, thereby leading to even further amendment. Another participant expressed concern that the proposed form would be part of a legislative history that might lock in a particular form with a particular proposal. It was further suggested that a tax-writing committee simply would not await the production of a form.

The application of integration formulas to exempt organizations on the one hand and to pension funds on the other was cited as a particular problem. They raise different questions because the exempt organization is wholly exempt, while the pension fund is a deferral device.

Professor Warren responded that to the extent that there is a difference between pension plans and other exempt entities, it is only where the rates are different or where the employee has made a contribution to the pension plan out of dollars that have borne taxes. Otherwise, the two are treated the same.

Concern was expressed that changes would be forced in techniques for funding pension plans simply because of the adoption of a particular type of integration proposal. Professor Warren, however, believed that it would be possible to work out solutions once the basic policy decisions had been taken.

It was suggested that full recapture of depreciation for real estate would result in a simplification, but would leave the advantage of deferral, which would be substantial because the depreciable life of real estate is so long. Mr. Kubik agreed that the establishment of full recapture for real estate would probably tend to reduce areas of argument. He said, however, that practitioners disagreed markedly with the Treasury view on the useful life of a building. Professor O'Byrne pointed out that controversy was still present because deductions were taken over a long period of time, but the recapture occurred in a single tax year.

One participant noted that the ADR proposals have been largely successful in eliminating a number of running controversies. The loss of revenue was less than originally anticipated because many taxpayers estimated lives on the basis of their own actual experience and were using shorter, useful lives. Nevertheless, there are areas in which the ADR regulations could be made simpler, and he would endorse an attempt to gain even a small measure of simplicity.

Another conferee indicated that it would be relatively easy to simplify the investment credit package. The Treasury proposed a year or so ago to eliminate the recapture, adjust the basis, and reduce the rates. The result would be that the incentive would remain but that there would be substantially greater simplicity. A refundable investment credit might be the key to simplifying the investment credit, but a reduction in basis should accompany the investment credit.

One participant pointed out that complexity in the ERISA area is not a manifestation of tax policy, but rather of broader social policy; but he concluded that there is now no way to remove the pension system from the tax structure.

Finally, reference was made to the fact that many Service officers are grossly overloaded with work. As a result, plans and provisions are being developed that are filled with potential problems. The structure demonstrates that a statute of such complexity may fall of its own weight.

Hugh Calkins then introduced the final portion of the morning's session, the status of Subchapter S. Professor Streng offered a number of observations. He noted that there have been suggestions with respect to the recognition of a new entity called a "small business enterprise." He would not favor such a development. A number of new problems would arise. For example, how many equity owners could there be? Could nonindividuals be equity owners? What would be the nature of

an acceptable equity ownership? What happens when an enterprise moves from one category to another? The shock to the system would exceed any degree of simplification that might be achieved.

There are some technical adjustments that could profitably be made with respect to Subchapter S. Too much emphasis has been placed upon the pass-through of losses. Simplicity could be attained by expanding the number of eligible shareholders and by eliminating passive income tests.

Mr. Kubik pointed out that a study by a committee of the AICPA proposed a complete revision of Subchapter S. It would eliminate the passive income requirements. It would eliminate the restriction of the number of shareholders, as long as a company was not subject to SEC jurisdiction. It would also eliminate the shareholder qualification requirements in terms of a corporation owning stock in a Subchapter S corporation.

Milton Stewart identified himself as the most recent chairman of the Council of Small and Independent Business Associations. His principal concern was not necessarily simplification, but rather equity. He suggested that for tax purposes small business transactions be lumped with transactions that are economically conceptually different. One conferee responded that systems involving selectivity on the part of taxpayers because of the substantial bookkeeping requirements may not result in substantial simplification.

6

Effects on Simplification of the Relationship Among the Federal and State and Local Income Tax Systems

Session: Friday Afternoon, January 6, 1978 (Part I)

Moderator: John H. Hall

Panelists: Dale S. Collinson
Daniel G. Smith
Otto G. Stolz

John H. Hall began this session by citing some of the differences between state and federal income tax laws that result in a substantial enlargement of the workload for taxpayers trying to satisfy the requirements of voluntary compliance. The increasing rate of change in the federal law is, moreover, increasing the magnitude of the differences.

One response to the trend was the enactment of the piggybacking provisions now set forth in Sections 6361 to 6365 of the Code. Although the provisions were enacted in 1972, however, there has been no meaningful movement on the part of the states to use the arrangement.

Professor Otto G. Stolz [1] noted that piggybacking reduces reporting, withholding, filing, and recordkeeping burdens for taxpayers and

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* John H. Hall is a member of Latham & Watkins, Los Angeles, California.

Dale S. Collinson is a member of Willkie, Farr & Gallagher, New York, New York.

Daniel G. Smith is the Director of Taxation of the Wisconsin Department of Revenue, Madison, Wisconsin.

Otto G. Stolz is a Professor of Law at the Duke University School of Law, Durham, North Carolina.

[1] Professor Stolz served as Special Counsel to the Treasury Department in 1972 and represented the Treasury Department before the Congress with respect to the piggybacking proposal. *See* Stolz & Purdy, *Federal Collection of State Individual Income Taxes,* 1977 Duke L.J. 59, which was distributed to the conferees but is not reproduced in this volume.

employees; reduces the cost of compliance to the taxpayer; and facilitates uniformity in determining residency requirements.

Professor Stolz analyzed data regarding the cost of administering a tax return. Although the data is modest, the administrative costs of processing a state return vary from $1.04 to $4.28. The median cost is about $2.33. The federal costs have been estimated at $1.30. He noted that the most detailed state figures available tended to be at the higher end of the spectrum, and suggested that the lower figures from other states may indicate a substantial absence of any significant enforcement effort.

Professor Stolz also analyzed the cost of collecting $100 in revenue. He warned, however, that comparisons with federal costs would be misleading because state revenues were substantially less. Moreover, the tax administration with the least enforcement activities may appear to be the most efficient when measured in these terms. Despite these reservations, the cost of administration with piggybacking should be substantially less. Since processing costs may approximate one half of the total administrative costs, it would appear that upon entering the federal collection system a typical state could expect to save more than half of its present administrative costs for the state individual income tax.

Although there is disagreement about the magnitude of cost savings to the states, the savings to a taxpayer in terms of his compliance burdens are obvious. The Commission on Federal Paperwork recently commented favorably on the desirability of implementing piggybacking arrangements.

Opponents among tax administrators, however, believe that the IRS staff is undermanned and that state audit efficiency is higher. State taxing officials indicate that more than four million man-hours are invested in the audit process. There is no way that the Internal Revenue Service is likely to assume such a heavy workload.

Professor Stolz tended to believe that the states could continue their supplemental audit activity. Moreover, the states could shift audit capability to the corporate side. The proposed regulations provide that the matter of supplemental state audits would be resolved by the Commissioner and the state in an agreement that would be entered into between the two parties. The agreement could specify a minimum level of federal audit activity within the state. The Commissioner, however, has expressed concern about the legality of delegating federal auditing authority. Professor Stolz believed that this concern is misplaced, since Congress has expressly reserved the supplemental audit capacity for states.

Professor Stolz concluded that, despite the potential advantage of doing so, it was unlikely that any significant number of states would embrace the piggybacking arrangements.

The next speaker was Daniel G. Smith, who reviewed the history of the piggybacking provisions.[2] He agreed that there were potential savings in administrative costs. There are areas, however, where it is difficult to reconcile the two tax structures. State circuit-breaking provisions provide relief for real estate taxes. If a piggybacking arrangement were effected, forms and additional contacts would have to be used in order to administer the circuit breaker program.

Mr. Smith questioned whether piggybacking would, in fact, make it more difficult for taxpayers to avoid state taxes. He noted that state tax administrators already compare their tax rolls periodically with those available through the Internal Revenue Service. Piggybacking might slow up the collection process. Although he conceded that there would be simplification in compliance, he noted that there would still be some very difficult mechanical problems when a taxpayer paid state income taxes to more than one jurisdiction. He observed that state legislators are increasingly concerned about their prerogatives. They would not be willing to acquiesce in every one of the increasingly frequent changes in federal tax laws. He also expressed concern about Internal Revenue Service audit activity. He analyzed statistics demonstrating that the amount expended on audit activities on the part of the Internal Revenue Service in Wisconsin, for example, was substantially less than the population percentage in that state. He doubted that the Internal Revenue Service would be willing to increase substantially its audit activities in Wisconsin to replace state audits that had been foresworn.

Finally, Mr. Smith emphasized that the political aspects of the question cannot be overlooked. Independence of policy, independence of administration, and outright patronage contribute to the reluctance of state officials to cede their power to the federal government.

The final speaker was Dale S. Collinson.[3] He suggested that all of the analysis about administration costs would be irrelevant to taxpayers. The only question is whether it would simplify the burden of compliance. As a way for states to exercise their own independence, he proposed a state credit that would be a percentage of the federal credit. His principal thesis was that there is not now a piggybacking statute that works. The statute has a provision on residency of trusts that raises constitutional policy issues, since it makes the sole dispositive tie the

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[2] Mr. Smith's Conference Paper is reproduced in Appendix II, pp. 463-502.

[3] Mr. Collinson's Conference Paper is reproduced in Appendix II, pp. 503-6.

residence of the creator of the trust or decedent of the estate. It allows a foreign tax credit under the percentage of tax method, which is inappropriate. The future may be a federal system with a definition of federal taxable income. Each state will then be able to make its adjustments thereto and to reflect the fiscal needs of a particular taxable period.

Mr. Hall opened the general discussion by questioning whether there was a typical state position with respect to these questions. Mr. Smith replied that there are many different positions asserted by different states.

One participant stated that it was important to press for piggybacking and conformity because quality of state tax administration generally is very low. Another conferee pointed out the enormous procedural differences at state and federal levels, which impede coordination efforts. Conformity of state laws as a means for achieving a measure of simplification was discussed by several participants, and several participants expressed the view that there was more chance for meaningful progress through conformity than piggybacking.

7

The Political Process of Achieving Simplification

Session: Friday Afternoon, January 6 (Part II)

Moderator:	John S. Nolan
Panelists:	Paul McDaniel Bernard M. Shapiro
Commentators:	Frederic W. Hickman Rick Koffey

The second portion of the afternoon session was devoted to the political process of achieving simplification. John S. Nolan, moderator of the session, mentioned that five years ago the Committee on Tax Policy of the Tax Section of the New York State Bar Association, under the chairmanship of Sidney I. Roberts, had published a report on simplification that recommended the establishment of the Blue Ribbon Commission. The Commission would be drawn from diverse groups, including members of the administrative branch, judges, officials of the Internal Revenue Service, members of professional organizations, and other knowledgeable people. The Commission would be assisted by a permanent staff, similar to the staff of the Joint Committee on Taxation, which would also be under the control of Congress. The recommendation was urged again in 1975 in hearings before the House Ways and Means Committee on tax simplification. Thus far, however, little progress has been made toward the achievement of any meaningful simplification objectives.

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* John S. Nolan is a member of Miller & Chevalier, Washington, D.C.

Paul McDaniel is a Professor of Law at Boston College Law School, Newton, Massachusetts.

Bernard M. Shapiro is Chief of Staff of the Joint Committee on Taxation of the United States Congress.

Frederic W. Hickman is a member of Hopkins, Sutter, Mulroy, Davis & Cromartie, Chicago, Illinois.

Rick Koffey is in the Office of the General Counsel of the United States Treasury Department.

The principal speaker for the afternoon was Professor Paul R. McDaniel,[1] who stated that the purpose of his paper was to examine in detail the nature of the political process, to identify the characters in it, and to ascertain the role that is or should be performed. Secondly, he endeavored to bridge the gap between theoretical solutions and practical political achievement.

Professor McDaniel offered as a working proposition that the Internal Revenue Code consists of two systems: the tax expenditure component and the normal or normative structure of the income tax. The criteria to be applied for determining what constitutes simplification and the objectives to be achieved are different with respect to the two systems. Also the political strategies necessary to achieve simplification will probably differ with respect to the two categories. The failure to recognize and to appreciate these differences will doom any major effort toward simplification.

Professor McDaniel suggested several conclusions. First, the Treasury Department must be the focal point for developing major studies in each of the two areas. The problem presently before Treasury derives from the growth of the tax expenditure concept. The number of tax expenditure programs during the past decade has almost doubled, and the dollar volume of those programs has grown by 260 per cent. In other areas of government, this would mean a substantial increase in the size of the staff. The size of the staff of the Tax Legislative Council, however, has not significantly changed since 1969. The staff is not capable of effecting the careful studies and analyses that would make a judgment about direct expenditure programs rational. Long range, complex, individual studies are required on many kinds of issues. It is insufficient merely to call for a comprehensive tax base. The Treasury Department must be able to devote manpower and resources to develop workable solutions.

A major problem is that tax expenditure restrictions have been drafted in terms of tax law, rather than in terms of eligibility definitions that would effect direct expenditure proposals. The restrictions often make no sense from a programmatic perspective. For example, if charitable contributions or medical expenses were viewed as spending programs, establishing a floor under the proposals would be contrary to basic policy objectives.

Professor McDaniel suggested that the major cause of complexity in the Code is the existence of tax expenditures. Further, the only way to achieve substantial simplification is to focus on these provisions and to

[1] Professor McDaniel's Conference Paper is reproduced in Appendix II, pp. 507–57.

determine which are needed, which can be substituted, which can be repealed, and which can be modified. Although it will lead to the eventual goal of establishing a comprehensive tax base, the task will be long and arduous.

Second, the Treasury Department must deal with structural provisions of the Code. In this context, conferences such as this are most likely to achieve meaningful results. Subchapters C, J, and K, and the foreign tax area were cited as portions of the Code requiring substantial revision for purposes of simplification. The Treasury Department staff has had no time to provide any meaningful research and analysis that would be necessary for a comprehensive revision of any one of these parts of the Code. Staff resources should be committed to the effort. Also the Treasury Department should work closely with such organizations as the American Law Institute, the Tax Section of the American Bar Association, and other interested groups. The Treasury Department should more aggressively encourage, fund, and cooperate closely with these outside groups. In the structural area, tax lawyers can probably make the greatest contribution; on the other hand, in the area of tax expenditures, tax lawyers have the least to contribute. In the Energy Tax Bill, for example, a number of Senators relied more heavily upon economists and lawyers who were more intimately involved with energy programs than upon tax lawyers.

The role of other departments of the executive branch must also be analyzed. As the tax expenditure concept expands, the involvement of other departments and agencies in the tax-writing process increases. Thus, for example, representatives of the Department of Health, Education, and Welfare contributed to discussions with respect to the college tuition tax credit. It is essential that the contribution be a constructive one. The position of these other agencies must be reconciled and made consistent with that of the Treasury Department. The Office of Management and Budget is probably the only agency capable of achieving this objective.

The development of the Energy Tax Bill exemplifies an absolutely wrong process. The energy tax package was developed almost entirely outside of the Treasury Department, with little opportunity for the Department to contribute until the very last minute. The same process is being undertaken with respect to the Urban Task Force. The ultimate responsibility in the Executive Branch, of course, lies with the Office of the President. It is there that policy should be refined and orchestrated.

Congress is in a transitional period. With respect to tax expenditures, the process is becoming increasingly rational. Involvement of the Congressional Budget Office and the Senate Budget Committee staff, pursuant to the requirements of the Budget Reform Act, however, will complicate, rather than simplify, the tax legislative process. More people are involved; more interested powers have to be reconciled.

Further, any proposal for tax simplification must take into account the committee jurisdiction of Congress. The tax expenditure route provides an opportunity for a representative or a senator to become involved in substantive legislation over which he would not otherwise have authority. The use of tax expenditures creates a system in which the authorization and appropriation process is vested in a single committee. In this respect, accumulation of power is a serious factor that confronts any change. This could be mitigated, however, by retaining jurisdiction in the same committee when shifting from tax expenditures to a direct program.

It is necessary to approach the problem on a realistic basis. Tax expenditure provisions are not going to be eliminated totally in the near future. Thus it is necessary to rationalize the process by eliminating unnecessary tax expenditures and by attempting to shift others to direct programs. Finally, lobbyists play an important role that must be taken into account. The effect of lobbying activities, including those by members of the Tax Bar, almost inevitably increases complexity.

Professor McDaniel concluded that, with respect to the tax expenditure system, the process is improving in terms of increasing rationality, understandability, efficiency, and equity; however, with respect to the legislative process and structural changes in the tax system, he was more skeptical.

Bernard M. Shapiro, Chief of Staff of the Joint Committee on Internal Revenue Taxation, said that the time was ripe for tax simplification. The Joint Committee Staff is very concerned with the result of conferences like this. The only way to achieve simplification is through small, potentially attainable steps. In this way, the ultimate goal of overall simplification might be achieved. Although agreeing with the analysis in Professor McDaniel's paper, Mr. Shapiro pointed out that personnel affects the structure of legislative events and that personnel is subject to change.

Mr. Shapiro expressed reservations about the use of a commission. He believed that the commission reports may merely become another factor in the political process in Congress without increasing the momentum toward the achievement of any definable goals.

At the present time, there are six factors that must be taken into account. The Deadwood Bill, which took 10 years to become law, provides many lessons. The Bill tried to do too much in one package. More rapid development might have occurred if smaller steps had been taken. Another lesson results from the advisory groups on Subchapters C, J, and K. Although many of the proposals were regarded as admirable, none were adopted.

The second major change is in the form of Congress. There are now subcommittees of the Ways and Means Committee and the Finance Committee.

Third, there has been a significant increase in the staff of the Joint Committee. The staff has tripled since the late 1960's. Three accountants have been added to the staff. The Committee has been working closely with the Government Accounting Office (GAO). The GAO, in performing its oversight role, has increased its expertise in tax policy and tax matters so that its staff can be more actively involved in the simplification process.

Fourth, there is a closer working relationship with outside groups.

Fifth, the staff of the Joint Committee has recently published a report on simplification.[2] Although the report has been characterized as bland, it should be recalled that the report is not a Committee report but a report of the staff. No significant recommendations could be included because the Joint Committee itself never reviewed the positions with a view to exercising its own judgment. Nevertheless, a substantial amount of expertise and background has been developed on the part of the staff through the process of preparing the report.

Sixth, there is the development of interest on the part of Congress in "sunset laws." This interest extends to providing termination dates on tax expenditures in order to provide an appropriate means and a forum for Congress to review tax expenditures regularly.

Mr. Shapiro then listed steps that have been taken. Last year there were extraordinary legislative measures underway. The Tax Reduction Bill arrived in January. Then, there was the Economic Stimulus Program and the energy bill. Finally, Staff initiatives were directed to the development of a Technical Corrections Act. The subcommittee approach was especially useful in preparing the technical revisions.

Also the staff is resurrecting some old projects that have not thus far led to any change. One of these is the Subchapter S proposal that has

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[2] STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS (September 19, 1977).

been worked on for over 10 years. An effort will be made to work with the Treasury and outside groups in this respect. The Staff is also involved in a considerable amount of work on Subchapter C. In the future, more attention will be devoted to Subchapters J and K, small business, inventories, and ERISA.

Finally, Mr. Shapiro observed that simplification requires not only the formulation of ideas but the development of draft language. Simplification might be substantially enhanced through drafting experts. In this context, drafting would be clearer and results substantially more satisfactory if time pressures in the legislative process could be mitigated. Often, there are only two or three days to draft legislation on the conference report. The quality of the work product is adversely affected by these pressures. It is hoped that a procedure can be developed wherein there is time to structure a package that is clear and that can be reviewed by outside consulting groups.

Rick Koffey, serving as a commentator, strongly disagreed with the proposal to increase Treasury staff, at least to the extent that it would apply to legal staff. Although there may be a need for more economists, there is no need for additional lawyers. Because of personal economic exigencies, most lawyers stay only two to two-and-one-half years. Administratively, it would be very difficult to organize a larger office. If, for example, the staff consisted of 40 lawyers, there would be a new employee almost every three weeks. Also inasmuch as lawyers stay for such a short time, it is impossible to become involved in the kind of long-range projects that Professor McDaniel proposes. It would be necessary to establish a relatively permanent staff, which Mr. Koffey believed would reduce the quality of its work product.

Mr. Koffey rejected the notion of a multiagency task force, which would operate under the Federal Advisory Act, with all of its attendant procedural problems. These organizations do not achieve great productivity in short periods of time. The process of securing generalized agency approval mitigates against the achievement of any meaningful results.

Finally, Mr. Koffey observed that all lobbyists, including lobbyists for tax reform, as well as those representing the beneficiaries of tax expenditures, contribute to the enactment of complicated provisions.

Frederic W. Hickman completed the panel presentation. Mr. Hickman emphasized that the subject of Professor McDaniel's paper is the principal object of the conference. He agreed that a larger staff would not necessarily improve the quality of the Treasury's work product.

Mr. Hickman emphasized that there are policy implications in all simplification proposals. When the policy issues are most significant, the technical analyses proposed in sessions such as these become less relevant. For example, in Illinois, even though the income tax was only a simple, flat 2½ per cent, there was substantial public hostility generated toward the treatment of capital gains as ordinary income.

Professor McDaniel offered a few closing remarks. Although an increase in staff is not essential to his proposal, he thought that the suggestion that it cannot be increased should be reconsidered. He agreed that a commission would probably have to represent such a wide spectrum of views that no consensus would ever be reached; if the commission did not represent a wide range of views, it would not have the necessary influence.

The discussion was then opened to all participants. It was suggested that the enlarging tax expenditure activity probably requires the addition of more economists, not lawyers, to the Treasury staff.

The opening of the legislative process during the past decade to more participation and increased public scrutiny was cited as a contribution to the acceptance of complicating compromise. Mr. Shapiro responded that the process was not likely to be reviewed and urged that any recommendation be considered with a full understanding of this political reality.

One participant, referring to the discussion of substantive issues in connection with simplification, expressed great pessimism about the prospect of simplification as long as certain assumptions, such as potential treatment of capital gains, was not open to serious challenge.

The session concluded with a discussion of the potential effect of the involvement of other legislative committees in the tax law-writing process that is likely to result from the expansion of tax expenditures.

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Report of the Conference

Michael J. Graetz

INTRODUCTION

This report is a summary of the results of the working sessions and the discussion by the conference participants. Issues considered in this report are those discussed in working group sessions; thus simplification issues are treated selectively rather than comprehensively. Government personnel were invited guests and presented important views, but did not participate in the conclusions of the conference. No formal votes on issues were taken, and no effort was made to produce specific legislative or administrative recommendations for income tax simplification. Rather, the purpose of the conference was to stimulate further discussion and consideration of income tax simplification issues among tax practitioners, educators, government officials, and the public. It is expected that subsequent conferences, sponsored by the American Law Institute-American Bar Association Committee on Continuing Professional Education and other interested organizations and modeled after the Airlie House Conference, will be held in different regions throughout the country. This report is intended to serve as a stimulus to further education and analysis and should ultimately become an agenda for income tax simplification. Specific issues will be discussed in an effort to advance formulation of a tax simplification agenda. Conference participants were acutely aware that specific simplification recommendations require careful analysis of their possible impact on other important tax policy objectives, including tax equity and economic and other social goals, and that firm judgments about these tradeoffs simply were inappropriate at this early stage of analysis.

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* Michael J. Graetz is a Professor of Law at the University of Virginia School of Law, Charlottesville, Virginia.

[EDITOR'S NOTE: The Conferees were divided into six working groups to discuss in more detail the main issues raised in the earlier general sessions. The final session of the Conference was devoted to reports from the working groups and a discussion of those reports. This summary, prepared by Professor Michael J. Graetz, is based upon the final session.]

This report, therefore, does not represent the views of The American Law Institute or the Section of Taxation of the American Bar Association. It does not necessarily represent the conclusions of a majority of conference participants. It is, instead, a summary of propositions that were put forth in the plenary session and had substantial support. The material is presented in the form of conclusions, rather than issues, in the hope that argument and disagreement with specific conclusions will help focus the discussion of the important issues raised.

THE NEED FOR NEW INITIATIVES

There was general agreement that extraordinary new initiatives to simplify the income tax are required. Unwarranted complications exist for every class of taxpayer and for every governmental institution with responsibility in the tax area. Many individuals are unable to understand tax forms and instructions, are often incapable of executing required computations, and are required to engage in unnecessary and burdensome recordkeeping. The Internal Revenue Service estimates that nearly 10 per cent of all Forms 1040 and nearly 12 per cent of Forms 1040A filed by individual taxpayers for 1976 contained mathematical errors.

For taxpayers with substantial income and for all classes of business taxpayers, income tax consequences of transactions are frequently overly expensive to ascertain and, in some cases, intractably uncertain, even after diligent research efforts. The lack of clarity and absence of predictability that mark the income tax law not only produce numerous controversies but also make resolution of such controversies unduly expensive for taxpayers and the government.

Far too often, income tax complexity and uncertainty lead taxpayers to engage in the "tax lottery"; taxpayers view their tax returns as an opening bid and resolve all ambiguities in their favor, with the hope that the return will not be selected for audit or that the revenue agent who audits the return will be unable to discover and prevail on questionable issues. Uncertainty increases the pressure on tax advisors to encourage clients to engage in the tax lottery and inhibits the ability of tax advisors to encourage compliance by their clients. The tax lottery and recent government responses to it, such as in the tax shelter context, provide an important example of the "dynamic complexity" in the tax

system, where new tax avoidance techniques result in an ongoing process of government reaction followed by new private responses.

Evidence of the impact of income tax complexity on government also abounds. Income tax forms are revised annually. The list of unfinished regulation projects grows apace, as does the number of controversial and uncertain issues in regard to which the IRS refuses to issue rulings. Pressures on IRS audit resources continue to mount. Administrators and legislators are, with increasing frequency, called upon to respond to new tax planning and reporting techniques designed in response to taxpayers' ongoing efforts to avoid taxes. The volume of tax litigation multiplies annually, and uncertainty and complexity have tended to produce a substantial decline in the percentage of cases settled.

In sum, the burdens of income tax complexity on taxpayers and government alike constitute a danger to the health of the income tax system and to this nation's continued reliance on self-assessment and voluntary compliance.

INSTITUTIONAL RESPONSES TO COMPLEXITY

The Role of Congress

As the institution with ultimate responsibility for producing income tax laws, Congress must become a major contributor to income tax simplification. Currently, no congressional body is charged with the responsibility to limit income tax complexity. Some mechanism within the Congress must be developed to insure that the goal of income tax simplification becomes a congressional priority. Toward this end, the oversight subcommittees of the House Ways and Means Committee and the Senate Finance Committee might be made responsible for evaluating the impact of new legislative programs on the administration of the tax laws and, in this connection, might assume the role of simplification policemen in the legislative process.

Second, attention should be given to developing new legislative procedures for enacting technical legislation to clarify or simplify the law in situations where no important countervailing policy considerations are at stake. In this regard, one technique used by the House Ways and Means Committee in connection with its consideration of the Technical Corrections Act of 1977 seems promising. This bill was developed by the staffs of the Treasury Department and the Joint Committee on Taxation to correct technical problems of the 1976 Tax Reform Act.

In an effort to limit this legislation to purely technical matters to insure its enactment, Chairman Ullman created an *ad hoc* subcommittee to rule on the germaneness of proposed amendments. Amendments raising significant policy questions were ruled out of order, and the bill passed by the House was essentially limited to technical corrections of the 1976 legislation. The refusal of the Senate to adopt a comparable procedure, however, has delayed passage of this legislation.

Third, Congress should discontinue its practice of advising the Internal Revenue Service to refrain from issuing regulations or rulings on specified issues, except in those cases in which Congress is itself willing to provide a substantive solution. Prohibiting the IRS from responding to controversial issues left unsolved by the Congress increases uncertainty and inhibits the proper administration of the tax laws. Examples of disrupting congressional directives include recent restrictions on the ability of the IRS to resolve important fringe benefit questions, as well as issues concerning when individuals are employees or independent contractors. Whenever Congress interferes with IRS administration of the tax laws, it should, at the same time, provide necessary substantive guidance to the public.

Fourth, Congress should further encourage the Joint Committee on Taxation to play a major role in developing proposals for simplification legislation, including short-term proposals in which continuance of existing policies may be generally assumed and long-term proposals in which simplification may require tradeoffs of other tax policy objectives, such as equity, economic efficiency, and other social goals. The support and advice of private experts will be important to this endeavor.

This conference did not view the process or techniques of drafting the Internal Revenue Code as an important contributor to income tax complexity; rather, drafting of the income tax laws was considered to be of high quality. Fewer technical problems will occur, however, if draftsmen are given adequate time to translate congressional policy decisions into statutory language.

The Role of the Executive

The burden of developing responses to problems of income tax complexity necessarily must lie with existing institutions of government. The executive branch has the ability to mass the resources, the information, and the manpower to undertake the overall task of discovering the major sources and causes of complexity, identifying and quantifying (wherever possible) the necessary tradeoffs with other tax policy objec-

tives, and developing proposals for change. Fundamental simplification of the income tax requires a major commitment by the executive branch, primarily from the Treasury Department with the personal support and encouragement of the President. This effort should focus on prospects for fundamental revision of structural provisions necessary to impose a tax on net income and should investigate the functioning of tax expenditure provisions with a view toward their elimination or restructuring, where appropriate. Evaluation of tax expenditure programs necessarily requires investigation into alternative direct expenditure programs and involves input from executive departments other than the Treasury. In this connection, the Treasury Department's tax policy staff must be adequate in size and must be organized in a way that will facilitate long range consideration of areas of the tax law where greater simplicity, clarity, and predictability are possible through more rational and coherent tax provisions. In this effort, the Treasury should enlist support and advice from private individuals and groups that possess relevant expertise.

Several areas in the administration of the current law were identified as contributing to tax complexity. As a first priority, greater emphasis must be placed on improving and expediting the issuance of regulations. Extraordinary new efforts are required in this regard, perhaps including expansion or reorganization of regulations staffs or both within the IRS and the Treasury. Second, the IRS should improve its program for issuing published rulings. Third, new audit techniques are necessary to insure appropriate auditing of returns and to combat the ingenuity of taxpayers and their advisors in playing the "tax lottery." Fourth, both the IRS and the Department of Justice must investigate new techniques to improve the disposition of cases in litigation, with particular emphasis on increasing the number of cases settled.

The Role of the Courts

The present system of judicial review of tax cases is itself a source of income tax complexity. A taxpayer may litigate a tax deficiency in the tax court or pay the tax, file a claim for refund, and file suit either in the appropriate district court or in the court of claims. Decisions of the tax court and the district courts may be appealed to the court of appeals for the circuit of the taxpayer's residence. The court of claims tends to be the final decisionmaker in cases brought to that court, since its decisions may be reviewed by the Supreme Court only by writ of *certiorari*. The Supreme Court rarely grants *certiorari* in tax cases, even

in instances in which diverse results have been reached by various courts of appeals. The present system of appellate review frequently produces substantial delay in achieving a final resolution of a litigated issue and results in considerable uncertainty for both the taxpayers and the government. From time to time during the past 35 years, commentators have urged the creation of a court of tax appeals, which would have sole jurisdiction over civil income, estate and gift, and excise tax matters. Others have suggested a revision of the judicial process at the trial level. These proposals offer the potential for greater certainty, speedier resolution, and more conformity of result in tax cases and merit reexamination in light of current problems.

The Role of Tax Professionals

Tax simplification is an issue that lacks a natural constituency. If political momentum for simplification is to be developed, tax professionals—attorneys, accountants, tax return preparers, and public finance economists—must play an active and aggressive role in encouraging and aiding the government to formulate responses to the problems of tax complexity. They must endeavor to obtain the commitment of the executive branch and the Congress to a program of tax simplification. Groups such as the American Bar Association, the American Institute of Certified Public Accountants (AICPA), the National Society of Public Accountants, and the American Law Institute should highlight problem areas and undertake the detailed research and analysis of particular areas of the law to produce suggestions for simplifying changes. In this connection, these groups should work closely with the staffs of the Treasury and the Joint Committee on Taxation. Recommendations of the AICPA and the Tax Section of the American Bar Association with regard to revision of Subchapter S of the Internal Revenue Code are excellent examples of the potential input of these kinds of organizations. In addition, these groups should assist the executive and legislative branches of government in achieving immediate improvements in the taxing system; for example, they should assist the IRS in developing new kinds of audit responses to deal with the "tax lottery."

This effort cannot be composed solely of tax advisors to businesses or high-income taxpayers. The tendency of lower- and middle-income taxpayers to turn to professional tax return preparers for assistance has been well documented. The Internal Revenue Service now estimates that approximately one half of all individual returns (many involving lower- and middle-income individuals) are prepared by paid preparers.

Persons and organizations involved in tax return preparation for these classes of taxpayers must also become involved in the simplification effort. Their input is critical to insure that the tax law is readily understandable by the average tax return preparer and average revenue agent, if not by the average taxpayer.

In connection with these observations, considerable attention was given to the proposal of the New York State Bar Association for a blue-ribbon commission on tax simplification. Many participants present at this conference believed that such a commission, sponsored and supported by the government, would provide an important new stimulus to simplification. A substantial majority of those who considered this issue in detail, however, concluded that this kind of commission would not be useful in promoting simplification; rather, simplification must occur through the existing political and institutional structure. Private individuals and groups should provide the impetus, the inspiration, and the demand for this process and should support it by making major substantive contributions.

SUBSTANTIVE FEDERAL INCOME TAX ISSUES

The issues described below are intended to be only an initial step toward developing an agenda for income tax simplification. Most of these observations are based upon the assumption that existing policy determinations will continue to be in force and that these ideas could be implemented in the near future.

This conference devoted considerable attention to a more comprehensive restructuring of the income tax base, along the lines described in *Blueprints for Tax Reform*, published by the Treasury Department in January 1977. Many of the participants believed that a "comprehensive income tax base" would provide important simplification gains. It was, however, recognized that the proposals for a comprehensive income tax base emanate principally from considerations of equity and economic neutrality, rather than simplification. Further studies of the proposals for a comprehensive tax base, such as those currently in progress by the Special Committee on Simplification of the Tax Section of the American Bar Association, will be required to determine whether this kind of major restructuring of the income tax base would provide simplification gains in the long run. Thus simplification issues raised by proposals for a comprehensive income tax base were deferred for later study and evaluation.

Simplification for Individual Taxpayers

Individual taxpayers who are not engaged in a trade or business except as employees have enjoyed certain simplifying amendments in recent legislation. The most important of these amendments occurred in the Tax Reduction and Simplification Act of 1977, which increased the level at which individuals become subject to income tax and thereby eliminated the need for many low-income individuals to file tax returns. This legislation also restructured the standard deduction into a "zero bracket amount," reflected in tax tables that were modified and expanded to include personal exemptions and the general tax credit so that most taxpayers might determine their tax liability from tables. These changes remove the source of three of the most frequent errors on the Forms 1040 and 1040A. Notwithstanding these improvements, however, complexities for the individual taxpayer abound.

The situation demands a deliberate and thorough review of all items of income exclusions, deductions, and credits, as well as rate categories, with emphasis on items that might be classified as tax expenditures. Of special concern is the congressional trend toward proliferation of inherently complex tax credits, such as the credits for child care expenses and retirement income, which, in many cases, complicate tax returns, including those of lower- and middle-income taxpayers who use the standard deduction. Examples of deductions that afford opportunities for simplification at little cost in equity or efficiency are itemized deductions for gasoline taxes and state sales taxes and the medical expense deduction limitation. Computations and limitations of the charitable deduction should be reviewed to determine whether this deduction might be simplified consistent with social policy objectives. Examples of provisions that produce excessive complexity in determining income include exclusions for scholarships and fellowships, for meals and lodging for the convenience of the employer, and for earned foreign income. In addition, the appropriate treatment of fringe benefits demands attention. Papers submitted to this conference have identified other areas in which potential simplification could be accomplished consistent with considerations of equity and economic efficiency; the complexities for many middle-income individuals attendant on the reporting of income and expenses in connection with renting a room in their home is one example.

Although the search for simplifying changes for individual taxpayers must necessarily begin with a review of the relevant statutory provisions, there is also a need for better interpretive aids to individual tax-

payers, including improved IRS regulations, rulings, general publications and instructions, and compliance procedures. The high incidence of mathematical errors on individual returns suggests that simplification might be achieved by expanding the number of situations in which the IRS computes individuals' income tax liability.

Finally, the goal of simplification for the individual taxpayer cannot be met by focusing only on the taxpayer himself. Efforts must be made to insure that the requirements of the income tax law are readily comprehensible to, and manageable by, tax return preparers and other tax advisors who play an important role in advancing voluntary compliance by individual taxpayers. Likewise, rules and procedures must not be overly confusing to IRS employees, particularly those charged with promoting individual compliance, such as revenue agents and taxpayer assistance personnel.

Simplification for Business Taxpayers

Complexities for business taxpayers occur in a great variety of contexts and stages of the taxation process. No single comprehensive solution to this problem seems likely to emerge. Therefore in the context of business taxpayers, income tax simplification must occur through a series of discrete steps in an ongoing effort to make the law simpler and clearer, to produce greater predictability, and to facilitate reporting of tax consequences of various business transactions.

At present, the most critical complexity for business taxpayers results from the rules and regulations under the Employee Retirement Income Security Act of 1974 (ERISA). This legislation was enacted in an effort to preserve and strengthen this nation's private pension system, but the detailed mechanisms for effectuating this social policy are so complex that noncompliance with specific paperwork requirements has become widespread, particularly among small businesses. In some cases, pension plans have been terminated or not adopted because of the burdensome requirements of ERISA. A major effort is needed to clarify and to simplify the requirements of ERISA consistent with the important social policy objectives of that legislation. One example of potential simplification worth careful consideration is the Internal Revenue Service effort to produce a simple model qualified pension plan for small businesses. Opportunities for simplifying the ERISA treatment of joint and survivor annuities should likewise be explored.

With respect to small businesses generally, existing income tax complexities and ambiguities cause few practical problems because revenue

agents simply do not apply the law as written. If IRS agents were to apply rigorously to small businesses the statutory and administrative rules relating to depreciation and inventories, the number of disputes would increase dramatically and costs of compliance for small businesses would suffer a sharp rise.

The current practice, however, of managing income tax complexity and ambiguity through discretionary revenue agent latitude is unsatisfactory. Even-handed administration of the tax law is impossible under these circumstances. In fact, taxpayers are likely to experience significant differences of treatment depending upon where they file tax returns. Moreover, officially sanctioned disregard of income tax rules because they are complex, ambiguous, or impractical to administer undermines the ability of the tax advisor or the tax return preparer to induce compliance with income tax rules generally and increases the tendency of taxpayers to engage in the "tax lottery." Tax advisors and return preparers are a principal resource for compliance; undermining their effectiveness in this regard poses a great risk to the taxing system.

It is crucial to the even-handed administration of the tax laws that steps be taken to insure greater clarity and simplicity in the income tax rules and procedures applicable to small businesses. For example, rules that require tax and financial accounting conformity in connection with inventories could be relaxed for businesses with no traded securities. The IRS could develop industry price indices and could otherwise simplify inventory rules to make the LIFO method of inventory readily usable by small businesses. Comparable simplification of the Asset Depreciation Range (ADR) regulations for small businesses would also make depreciation allowances more readily determinable. Attention should also be directed to the potential elimination of statutory distinctions that complicate tax computations without serving any important purpose, such as the rules relating to the carryover of deductions for farm land improvements.

In some instances, Congress has enacted provisions designed to provide special beneficial treatment to small businesses, but technical difficulties and unnecessary restrictions have reduced their usefulness. In 1958, for example, Congress enacted Subchapter S of the Internal Revenue Code to enable small businesses to be organized as corporations without the burden of a separate corporate income tax. These provisions have not fulfilled their original promise due to technical difficulties that have evolved over the past 20 years. Various organizations, including the Treasury Department (in its tax option papers), the American Institute of Certified Public Accountants (AICPA), the Tax Section of

the American Bar Association, and the staff of the Joint Committee on Taxation, have studied these difficulties and advanced recommendations. These recommendations should now be used by the Congress to amend Subchapter S to enable it to accomplish its original purpose. In liberalizing the rules of Subchapter S, however, care should be taken so that those rules do not become a vehicle for tax shelter abuse.

In addition to the changes recommended to clarify and simplify the taxation of small businesses, three other important actions could be taken immediately to simplify the taxation of businesses generally. First, the Internal Revenue Service could adopt the philosophy and practice of announcing its substantive interpretations and procedures at an earlier stage. Subsequent reversal of an administrative interpretation is less disruptive to tax advisors and return preparers than the necessary uncertainty that occurs when the IRS fails to announce its position. Second, the IRS and Congress should attempt to establish more "safe harbor" rules so that taxpayers might know with certainty the tax consequences of transactions. This practice would encourage taxpayers to accept certainty of result, rather than risk controversy or increased tax. Third, greater flexibility, certainty, and equity for taxpayers could be achieved by relaxing the rules relating to tax elections. Present law and administrative practice impose disproportionate tax consequences on the failure to make certain elections in a timely fashion.

There are other aspects of business taxation that may afford opportunities for simplification but involve important considerations of tax equity and economic and social policy. These areas therefore require further research and analysis. Perhaps the two most important concerns of this nature are the rules relating to recovery of capital investments and the proposals for integration of the corporate and individual income taxes. In the area of capital recovery, for example, there is the fundamental question of whether the investment tax credit could be profitably replaced by liberalized depreciation rules, thereby eliminating the complexities inherent in determination of investment credit eligibility and amount. At a less fundamental level, the opportunities for simplification by substituting an investment credit basis adjustment for the current recapture and useful life provisions should be explored, as should the potential simplification advantages of making the investment credit refundable. A refundable investment credit would eliminate the practice of businesses with tax losses of leasing rather than purchasing equipment in an effort to obtain some of the benefits of the investment credit.

Integration of the corporate and individual income taxes is another

appropriate area for study in considering simplification of the income tax laws. There are many aspects of this issue that have not been fully explored so that the extent to which integration offers potential simplification benefits is, as yet, unknown. Undoubtedly, different problems arise with full integration, which taxes retained and distributed corporate earnings to shareholders, than with partial integration, which eliminates only double taxation on earnings distributed, or with partial-partial integration, which is partial relief on distributed earnings.

If any form of corporate and individual tax integration is considered, emphasis and attention should be given to a simple method. For example, efforts should be made to develop a mechanism of integration that does not require any definition of corporate economic income, as would be required in a system that passes through or washes out corporate preference income on a pro rata basis when distributions are made to shareholders.

In analyzing the possibility of the integration of the corporate tax, it will be necessary to investigate the relationship of integration, taxation of capital gains, and the progressivity of the rate structure. Issues to be addressed include whether integration would further the elimination of special treatment of capital gains and whether such elimination, in connection with the lowering of the top rates of tax, is a desirable method of simplification.

Taxation of Capital Gains and Transfers of Assets

The basic question of whether the different rates of tax on ordinary income and capital gains should be eliminated involves fundamental concepts of tax equity and important economic and social policy considerations. The case for or against eliminating this differential will ultimately be grounded on policy considerations other than simplification. Accordingly, a substantive recommendation on this important issue was considered inappropriate for this conference on income tax simplification.

The degree of simplification that would result from elimination of the capital gains rate differential was, however, discussed in some detail, with participants expressing widely divergent views. The extent to which simplification gains would result from elimination of the rate differential would depend on how related policy issues would be resolved. Issues that would affect the degree of simplification include the treatment of capital losses; whether a basis adjustment for inflation is provided; the scope and details of exceptions, if any, to the general rule; the changes, if any, in the treatment of distribution from corpora-

tions to shareholders, including possible integration of the corporate and individual income tax; the treatment of gains and losses realized by entities other than individuals, such as trusts; the changes, if any, in nonrecognition rules; and the accompanying revisions of the progressive rate structure and income definition. The need to resolve such issues led this conference to conclude that further study is warranted before potential simplification consequences from eliminating the capital gains rate differential can be adequately evaluated.

Other aspects of capital gains taxation, however, present opportunities for substantial simplification in the short run. Examples include the following:

(1) The minimum tax provisions (Sections 56-58) and the maximum tax provisions (Section 1348) are primarily additional taxes on capital gains, in the sense that more than 80 per cent of the revenue raised by these taxes comes from capital gains. These provisions produce substantial complexity, much of which might be eliminated by taking capital gains out of the scope of these provisions and substituting a direct increase in the capital gains tax. Consideration should be given, for example, to eliminating capital gains as a defined "preference" for the purpose of the tax on capital gains and amending the capital gains rules to provide that, for example, only 40 per cent, rather than 50 per cent, of capital gains be excluded from income.

(2) Repeal of the provisions permitting a maximum 25 per cent alternative tax on the first $50,000 of capital gains merits attention. This provision has no effect on persons subject to a maximum marginal rate of 50 per cent or less and results in a maximum tax savings of $5,000 for persons in the 70 per cent bracket but substantially complicates instructions for reporting capital gains for all taxpayers.

(3) Consideration should be given to modifying the treatment of sales and certain other dispositions of assets used in a trade or business under Section 1231 of the Code, which taxes gains as capital gains but treats losses as ordinary losses. The possibility of treating both gains and losses as ordinary rather than capital should be explored.

(4) Capital gains are presently taxed at a maximum 35 per cent effective rate (ignoring the minimum and maximum tax), but, for technical reasons, tax shelter losses and other deductions that offset those gains can be deducted at a 70 per cent rate. This discrepancy produces undue incentives for complex tax planning. Whether some relatively simple mechanism can be devised to apply losses against capital gains in such a way that the losses will not reduce the tax at a greater rate than the gain

increases the tax should be considered. This is but one example of the dynamic complex tensions that result from the existence of high progressive rates.

(5) Much simplification could be achieved by revising the rules governing the taxation of sales of assets for future payments, particularly the requirements for installment sale treatment under Section 453 of the Code. Five simplifying amendments that do not significantly impinge on other tax policy considerations are offered. First, the installment sales provisions could be revised to make installment sale treatment the normal, rather than elective, method of reporting. Among other advantages, this change would have the effect of eliminating controversies concerning whether the purchase price is so indefinite that installment sale treatment is not available. Second, the current requirement that installment sale qualification demands two installment payments is a trap for the unwary and should be eliminated. Third, the requirement that the initial payment not exceed 30 per cent of the purchase price in certain cases, a requirement that has produced about one half of the installment sales litigation, should be eliminated. Fourth, ratable recovery of basis might be applied to all sales for deferred payment. Finally, distinctions that arise under present law so that essentially similar transactions produce different tax treatment depending upon whether the buyer is a corporation (for example, Section 1232) should be eliminated.

OBSERVATIONS RELATING TO THE RELATIONSHIP BETWEEN THE FEDERAL AND THE STATE INCOME TAX SYSTEMS

Most individuals and businesses must not only deal with the complexities of the federal income tax but also with income tax laws of one or more state and local governments. Many state income tax laws diverge substantially from the federal law. This divergence increases planning, recordkeeping, and reporting costs for taxpayers and often results in unnecessary additional administrative expenses by the state. Minimizing differences between federal and state income tax laws would reduce uncertainties and costs for taxpayers and state governments alike.

This conference explored in some detail the potential for piggybacking of state income taxes on the federal income tax system. Under piggybacking, state income taxes would be determined by applying the state tax rate schedule to the taxpayer's federal taxable income, as modified by certain required and permitted adjustments. Alternatively,

state income taxes would be determined as a percentage of the taxpayer's federal tax liability, as modified by certain adjustments. Although substantial simplification gains could be achieved to the extent that states are willing to adopt piggybacking income tax systems, most states resist piggybacking, principally for reasons of state political autonomy in fiscal management. Piggybacking may also involve tradeoffs, since it might, in certain circumstances, lessen the visibility of state institutions with both legislative and administrative responsibilities. Thus efforts at the federal level to force states into piggybacking their state income taxes on the federal system are likely to be unproductive.

Instead, the effort should be on revising state income tax laws so that they substantively conform closely to the federal income tax. Federal-state conformity in income tax provisions would substantially lessen the burden of taxpayers in filing returns and in keeping records. This conformity would also produce greater efficiency in administration of the tax laws. Promulgation of a uniform or a model state income tax act could provide considerable impetus to greater conformity between the state and local income taxes and the federal tax law. The project of drafting a model or a uniform act should be undertaken by an appropriate prestigious body, such as the National Conference of Commissioners on Uniform State Laws.

In a model state income tax statute, the preferred mechanism for achieving uniformity is to tie the state tax to taxable income (rather than to adjusted gross income) as computed under the federal income tax. Using federal taxable income as the state base, however, does not require precise overlapping. Several adjustments might be necessary or appropriate. These adjustments might include: (1) adding to or eliminating from the state tax base interest on federal obligations; (2) adding to the state tax base the amount of state income tax that is deducted under the federal tax; (3) adding to the state tax base interest on state and local obligations; and (4) providing, in certain cases, a basis adjustment keyed to the date of adoption of state income tax for calculating capital gains under the state statute.

In addition, certain credits, optional for the states, could be permitted under the uniform or model act. These credits might include: (1) a credit for sales tax paid to the state; (2) a credit for property tax paid to the state to accommodate circuit breaker arrangements; and (3) a credit for income taxes paid to other states. Additional simplification might be achieved by providing one credit under the model state act in the form of a stated percentage of all federal tax credits other than the foreign tax credit, the credit for withholding taxes paid, and any general tax

credit that might be adopted in lieu of the present federal personal exemption. The model act should permit the states to substitute a personal exemption for any federal personal credit or to adopt their own per person general tax credit. To protect the states against sudden reductions (or increases) in the federal taxable income base, the model or uniform act might allow the states to adopt an automatic surcharge (or tax reduction), which would enable the states to maintain the revenue level that they had anticipated.

It is important that the federal government take steps to encourage adoption by the states of a uniform or model act. As a possible inducement to adoption of a model act, for any state that adopts the model act, the federal government might elevate the state tax claim to the level of a federal tax claim as a matter of priority with respect to a debtor who is insolvent. Another possible inducement would be to provide states that adopt the conforming act with greater information for use in enforcing their state income tax. Federal assistance could also be offered to conforming states in collecting taxes from individuals who have moved to another state. Conforming states might also be exempted from any user charges that might be levied by the federal government for supplying information from federal records.

Finally, after a model or a uniform act has been produced, attention should be given to amending the piggybacking provisions of the Internal Revenue Code to make them more readily usable by any state that wishes to adopt an arrangement for piggybacking onto the federal tax system.

Although conformity of individual state income tax systems with the federal system is considered to be of high priority, there is also need for simplification of state taxation of interstate income and of corporate and business income generally.

These proposals are intended to stimulate the development of practical steps that could be taken toward income tax simplification. That important objective will be achieved, not quickly or effortlessly, but only through the persistent efforts of government officials and informed citizens.

Appendix I

A

PANELISTS AND COMMENTATORS

Mr. Gerard M. Brannon
Professor of Economics
Georgetown University
Washington, D.C. 20001

Dale S. Collinson, Esquire
Willkie, Farr & Gallagher
One Chase Manhattan Plaza
New York, New York 10005

Meade Emory, Esquire
LeSourd, Patten, Fleming,
Hartung & Emory
1300 Seattle Tower
Seattle, Washington 98101

The Honorable M. Carr Ferguson
Assistant Attorney General
(Tax Division)
Department of Justice
Constitution Avenue &
9th Street, N.W.
Washington, D.C. 20530

Mr. Harvey Galper
Associate Director
Office of Tax Analysis
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Martin D. Ginsburg, Esquire
Weil, Gotshal & Manges
767 Fifth Avenue
New York, New York 10022

David G. Glickman, Esquire
Jenkens & Gilchrist
2200 First National Bank Building
Dallas, Texas 75202

William M. Goldstein, Esquire
Morgan, Lewis & Bockius
1800 M Street, N.W.
Washington, D.C. 20036

John H. Hall, Esquire
Latham & Watkins
555 S. Flower Street
Los Angeles, California 90071

Frederic W. Hickman, Esquire
Hopkins, Sutter, Mulroy, Davis &
Cromartie
One First National Plaza
Suite 5200
Chicago, Illinois 60603

Ward M. Hussey, Esquire
Legislative Counsel
U.S. House of Representatives
136 Cannon House Office Building
Washington, D.C. 20515

Rick Koffey, Esquire
Office of the General Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Howard G. Krane, Esquire
Kirkland & Ellis
200 E. Randolph Drive
Chicago, Illinois 60601

J. Fred Kubik, C.P.A.
F. B. Kubik & Company
125 North Market Street
Suite 925
Wichita, Kansas 67202

The Honorable Jerome Kurtz
Commissioner of Internal Revenue
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

John R. Lindquist, Esquire
McDermott, Will & Emery
111 West Monroe Street
Chicago, Illinois 60603

Harry K. Mansfield, Esquire
Ropes & Gray
Room 2400
225 Franklin Street
Boston, Massachusetts 02110

Mr. Paul R. McDaniel
Professor of Law
Boston College Law School
885 Centre Street
Newton, Massachusetts 02159

Mr. Charles McLure, Jr.
Executive Director of Research
National Bureau of Economic Research
1050 Massachusetts Avenue
Cambridge, Massachusetts 02138

Mr. John O'Byrne
Visiting Professor of Law
University of Georgia School of Law
Athens, Georgia 30602

Sidney I. Roberts, Esquire
Roberts & Holland
1301 Avenue of the Americas
New York, New York 10019

Ms. Deborah H. Schenk
Associate Professor
Brooklyn Law School
250 Joralemon Street
Brooklyn, New York 11201

Stuart Seigel, Esquire
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Bernard M. Shapiro, Esquire
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

Mr. Daniel G. Smith
Director of Taxation
Wisconsin Department of Revenue
201 E. Washington Avenue
Madison, Wisconsin 53702

Mr. Otto G. Stolz
Professor of Law
Duke University School of Law
Durham, North Carolina 27706

Mr. William P. Streng
Professor of Law
Southern Methodist University School of Law
Dallas, Texas 75275

Mr. James M. Verdier
Deputy Assistant Director for Tax Analysis
Congressional Budget Office
House Annex 2
Second and D Streets, S.W.
Washington, D.C. 20515

Mr. Alvin C. Warren
Professor of Law
University of Pennsylvania Law School
3400 Chestnut Street
Philadelphia, Pennsylvania 19104

Mr. James W. Wetzler
Chief Economist
Joint Committee on Taxation
1010 Longworth House Office Building
Washington, D.C. 20515

B

CONFEREES

M. Bernard Aidinoff, Esquire
125 Broad Street
New York, New York 10004

Professor William D. Andrews
Harvard University Law School
Cambridge, Massachusetts 02138

Alan J. B. Aronsohn, Esquire
Room 2125
230 Park Avenue
New York, New York 10017

Mac Asbill, Jr., Esquire
1666 K Street, N.W.
Washington, D.C. 20006

Edward B. Benjamin, Jr., Esquire
28th Floor
225 Barrone Street
New Orleans, Louisiana 70112

Professor Walter J. Blum
University of Chicago Law School
1111 E. 60th Street
Chicago, Illinois 60637

Mr. Gerard M. Brannon
Professor of Economics
Georgetown University
Washington, D.C. 20001

Harvie Branscomb, Jr., Esquire
Branscomb & Miller
1700 Corpus Christi Bank & Trust Tower
Corpus Christi, Texas 78477

Hugh Calkins, Esquire
Jones, Day, Reavis & Pogue
1750 Union Commerce Building
Cleveland, Ohio 44114

Sheldon S. Cohen, Esquire
1775 K Street, N.W.
Washington, D.C. 20036

Haskell Cohn, Esquire
One Center Plaza
Boston, Massachusetts 02108

Dale S. Collinson, Esquire
Willkie, Farr & Gallagher
1 Chase Manhattan Plaza
New York, New York 10005

Professor George Cooper
Columbia University
School of Law
435 W. 116th Street
New York, New York 10027

Dave L. Cornfeld, Esquire
100 N. Broadway
Suite 1800
St. Louis, Missouri 63102

Edward O. Craft, Esquire
703 S. Rose Street
Bloomington, Indiana 47401

The Honorable R. Ammi Cutter
62 Sparks Street
Cambridge, Massachusetts 02138

Mr. Charles Davenport
Assistant Director for Tax Analysis
Congressional Budget Office
Second and D Streets, S.W.
Washington, D.C. 20515

The Honorable William Miller Drennen
U. S. Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

H. Stewart Dunn, Jr., Esquire
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Meade Emory, Esquire
Le Sourd, Patten, Fleming, Hartung & Emory
1300 Seattle Tower
Seattle, Washington 98101

The Honorable C. Moxley Featherston
U. S. Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

Arthur Feder, Esquire
Fried, Frank, Harris, Shriver & Jacobson
120 Broadway
New York, New York 10005

The Honorable M. Carr Ferguson
Assistant Attorney General
(Tax Division)
Department of Justice
Constitution Avenue & 9th Street, N.W.
Washington, D.C. 20530

Mr. Seymour Fiekowsky
Department of the Treasury
Room 4205
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Mr. Thomas F. Field
Executive Director
Tax Analysts and Advocates
2369 N. Taylor Street
Arlington, Virginia 22207

The Honorable Bruce M. Forrester
U. S. Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

Mr. Harvey Galper
Associate Director
Office of Tax Analysis
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dean Charles O'Neill Galvin
Southern Methodist University
School of Law
Dallas, Texas 75275

Martin D. Ginsburg, Esquire
Weil, Gotshal & Manges
767 Fifth Avenue
New York, New York 10022

David G. Glickman, Esquire
Jenkens & Gilchrist
2200 First National Bank Building
Dallas, Texas 75202

Gersham Goldstein, Esquire
Davies, Biggs, Strayer, Stoel & Boley
900 S.W. 5th Avenue
Portland, Oregon 97204

William M. Goldstein, Esquire
Morgan, Lewis & Bockius
1800 M Street, N.W.
Washington, D.C. 20036

Professor Michael Graetz
University of Virginia School of Law
Charlottesville, Virginia 22901

Erwin N. Griswold, Esquire
Jones, Day, Reavis & Pogue
Room 1200
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036

Professor Charles H. Gustafson
Georgetown University Law Center
600 New Jersey Avenue, N.W.
Washington, D.C. 20001

William N. Haddad, Esquire
Room 3400
135 S. LaSalle Street
Chicago, Illinois 60603

The Honorable Cynthia Holcomb Hall
U. S. Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

John H. Hall, Esquire
Latham & Watkins
555 S. Flower Street
Los Angeles, California 90071

Mr. Elmer Hechinger
561 Maitland Avenue
Altamonte, Florida 32701

Frederic W. Hickman, Esquire
Hopkins, Sutter, Mulroy, Davis & Cromartie
One First National Plaza
Suite 5200
Chicago, Illinois 60603

Ward M. Hussey, Esquire
Legislative Counsel
U. S. House of Representatives
136 Cannon House Office Building
Washington, D.C. 20515

Edwin L. Kahn, Esquire
Arent, Fox, Kintner, Plotkin & Kahn
1815 H Street, N.W.
Washington, D.C. 20006

Mr. Marvin Katz
Assistant to the Commissioner
Internal Revenue Service
Room 3011
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Rick Koffey, Esquire
Office of the General Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Howard G. Krane, Esquire
Kirkland & Ellis
57th Floor
200 E. Randolph Drive
Chicago, Illinois 60601

J. Fred Kubik, C.P.A.
F. B. Kubik & Company
125 North Market Street
Suite 925
Wichita, Kansas 67202

The Honorable Jerome Kurtz
Commissioner of Internal Revenue
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Thomas V. Lefevre, Esquire
Morgan, Lewis & Bockius
123 S. Broad Street
Philadelphia, Pennsylvania 19109

James B. Lewis, Esquire
345 Park Avenue
New York, New York 10022

John R. Lindquist, Esquire
McDermott, Will & Emery
111 West Monroe Street
Chicago, Illinois 60603

The Honorable Donald C. Lubick
Deputy Assistant Secretary for Tax Policy
Department of the Treasury
Room 3122
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Warren V. Ludlam, Jr., Esquire
P.O. Box 427
Jackson, Mississippi 39201

Mr. Alvin D. Lurie
Assistant Commissioner
Employee Plans and Exempt Organizations
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Harry K. Mansfield, Esquire
Ropes & Gray
Room 2400
225 Franklin Street
Boston, Massachusetts 02110

Professor Paul R. McDaniel
Boston College Law School
885 Centre Street
Newton, Massachusetts 02159

Mr. Charles E. McLure, Jr.
Executive Director of Research
National Bureau of Economic Research
1050 Massachusetts Avenue
Cambridge, Massachusetts 02138

Professor John K. McNulty
University of California
School of Law
Berkeley, California 94720

Patricia A. Metzer, Esquire
Room 3064
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Max E. Meyer, Esquire
Lord, Bissell & Brook
115 S. LaSalle Street
Chicago, Illinois 60603

John S. Nolan, Esquire
Miller & Chevalier
1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Professor John O'Byrne
University of Georgia
School of Law
Athens, Georgia 30602

Pamela J. Pecarich
Staff Director
Oversight Subcommittee
House Ways and Means Committee
1539 Longworth House Office Building
Washington, D.C. 20515

William C. Penick, Esquire
Arthur Anderson & Co.
1666 K Street, N.W.
Washington, D.C. 20006

Sidney I. Roberts, Esquire
Roberts & Holland
1301 Avenue of the Americas
New York, New York 10019

Alan L. Rothenberg, Esquire
Assistant Minority Counsel
House Ways and Means Committee Minority Counsel
Room 1105
Longworth House Office Building
Washington, D.C. 20515

Mr. Gabriel G. Rudney
Room 4217
Department of the Treasury
15th & Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Mr. John M. Samuels
Office of the Secretary
Department of the Treasury
Room 4422
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Professor Deborah H. Schenk
Brooklyn Law School
250 Joralemon Street
Brooklyn, New York 11201

Stuart Seigel, Esquire
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

John J. Sexton, Esquire
Arent, Fox, Kintner, Plotkin & Kahn
1815 H Street, N.W.
Washington, D.C. 20006

Mr. John Shannon
Advisory Commission on Intergovernmental Relations
726 Jackson Place, N.W.
Washington, D.C. 20575

Bernard M. Shapiro, Esquire
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office
Building
Washington, D.C. 20515

Professor Ira B. Shepard
University of Houston
College of Law
Houston, Texas 77004

Leonard Silverstein, Esquire
1776 K Street, N.W.
Washington, D.C. 20006

Mr. Robert C. Skinner
Ernst & Ernst
1300 Union Commerce Building
Cleveland, Ohio 44115

Mr. Daniel G. Smith
Director of Taxation
Wisconsin Department of Revenue
201 E. Washington Avenue
Madison, Wisconsin 53702

Mr. Milton D. Stewart
Research Council for Small
Business & the Professions
1404 New York Avenue, N.W.
Washington, D.C. 20005

Professor Otto G. Stolz
Duke University
School of Law
Durham, North Carolina 27706

Professor Lawrence M. Stone
1800 Avenue of the Stars
Suite 900
Los Angeles, California 90067

Mr. William P. Streng
Professor of Law
Southern Methodist University
School of Law
Dallas, Texas 75275

Mr. Emil M. Sunley, Jr.
Room 3108
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Professor Stanley S. Surrey
Harvard University Law School
Cambridge, Massachusetts 02138

Mr. James M. Verdier
Deputy Assistant Director for
Tax Analysis
Congressional Budget Office
House Annex 2
Second and D Streets, S.W.
Washington, D.C. 20515

Professor Alvin C. Warren
University of Pennsylvania
Law School
3400 Chestnut Street
Philadelphia, Pennsylvania 19104

David E. Watts, Esquire
140 Broadway
New York, New York 10005

Mr. James W. Wetzler
Chief Economist
Joint Committee on Taxation
1010 Longworth House Office
Building
Washington, D.C. 20515

Mervin M. Wilf, Esquire
2020 Packard Building
Philadelphia, Pennsylvania 19102

Mr. John L. Withers
Assistant Commissioner, Technical
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Professor Bernard Wolfman
Harvard University
Law School
Cambridge, Massachusetts 02138

Paul A. Wolkin, Esquire
Executive Director
American Law Institute-
American Bar Association
Committee on Continuing
Professional Education
4025 Chestnut Street
Philadelphia, Pennsylvania 19104

Mr. Alfred F. Yaude
National Society of Public
Accountants
4316 Argule Drive
Charlotte, North Carolina 28213

C

CONFERENCE AGENDA

Thursday, January 5 (9:00 a.m. to 12:00 noon)

Subject

Basic Considerations in Tax Simplification—An Overview

Moderator

Professor Stanley S. Surrey
Harvard Law School

Discussion Leaders

Professor Gerard M. Brannon
Georgetown University

Harvey Galper
Associate Director for Tax Analysis
U.S. Treasury Department

Sidney I. Roberts, Esquire
Roberts & Holland
New York, New York

Professor Deborah Schenk
Brooklyn Law School

The primary purpose of this session will be to introduce the major themes of the Conference. The different meanings of "simplification" will be considered from various perspectives in the system to facilitate the analysis of the effects of simplification from all relevant viewpoints.

Professor Schenk, who has been administering a program providing assistance to low- and middle-income taxpayers, will discuss the impact of simplification on the "average" individual taxpayer. The discussion will include an assessment of the importance of simplification in fostering voluntary compliance with tax laws and in expanding taxpayer awareness of entitlement to special tax benefits. The effect of simplification on the need for taxpayer assistance by the Internal Revenue Service and upon taxpayer reliance on tax return preparers will also be assessed.

Sidney Roberts will discuss the effect of complexity and the impact of simplification on the work of practicing tax lawyers. Specific sources of concern about complexity will be identified, and prospects for meaningful improvement through simplification will be assayed. Discussion of the practitioner's perspective will include consideration of the impact of the inclusion in the taxing system of tax expenditures, the effect of complexity on the audit process, the impact of complexity on the development of adequate and

comprehensible regulations and rulings, and the identification of areas where complexity may be unavoidable.

Harvey Galper will discuss the impact of simplification on efforts to establish a more comprehensive definition of the income tax base. Relationships between tax equity and simplification will be analyzed in the context of proposals affecting the definition of gross income, the availability of deductions and credits, and the determination of tax rates.

Professor Brannon will discuss the relationship between simplification and the design of tax expenditure programs. Factors in the design of tax expenditure programs leading toward increased complexity will be identified and reviewed. The design of such tax expenditure programs will be compared to the design of aspects of the taxing structure, such as the treatment of fringe benefits or entertainment expenses, that have traditionally been recognized as part of the taxing system. Simplification as a policy objective will be compared to such objectives as fairness and efficiency in the operation of the taxing mechanism.

Thursday, January 5 (2:00 p.m. to 5:30 p.m.)

Subject

Simplification for Individual Taxpayers

Moderator

Harvie Branscomb, Jr., Esquire
Branscomb & Miller
Corpus Christi, Texas

Discussion Leaders

Martin D. Ginsburg, Esquire
Weil, Gotshal & Manges
New York, New York

Frederic W. Hickman, Esquire
Hopkins, Sutter, Mulroy, Davis & Cromartie
Chicago, Illinois

William M. Goldstein, Esquire
Morgan, Lewis & Bockius
Washington, D.C.

Harry K. Mansfield, Esquire
Ropes & Gray
Boston, Massachusetts

Commentators

David G. Glickman, Esquire
Jenkins & Gilchrist
Dallas, Texas

James M. Verdier
Deputy Assistant Director for Tax Analysis
Congressional Budget Office

James W. Wetzler
Chief Economist
Joint Committee on Taxation
United States Congress

This session will be devoted to an examination of the impact of simplification on individual taxpayers. Panelists will address a series of issues arising for individual taxpayers that are intended to represent the vast array of issues that could appropriately be discussed. To the extent possible, social and economic objectives manifest in the provisions of the existing tax laws will be accepted. Presentations and discussions will, therefore, be devoted in part to an examination of the alternative means for achieving such objectives.

Frederic Hickman will discuss the complexities created by the special treatment of capital gains. The presentation will include an analysis of proposals to modify and/or eliminate long-term capital gains benefits as well as proposals to mitigate against the effects of inflation in taxing such gains.

Harry Mansfield will discuss the system of personal deductions. The treatment of charitable contributions will be used as a focus of analysis with a view to considering whether there might be alternative means of advancing charitable purposes. Alternative methods of simplifying the existing structure of personal deductions will also be considered.

Martin Ginsburg will discuss the impact of simplification on the ownership of real estate. Alternative means of encouraging home ownership will be analyzed. The effect of simplification on real estate shelters will be explored.

William Goldstein will discuss the effects of simplification on elderly taxpayers. The taxation of retirement income and the relationships between income taxes and the Social Security system will be considered.

In addition to the foregoing presentations, **David Glickman** will offer some observations about the impact of simplification on individual investors in oil and gas ventures. Further, **James Verdier** and **James Wetzler** will comment on the various presentations from the perspective of the budget-maker and the legislature.

Thursday, January 5 (7:30 p.m. to 9:30 p.m.)

Subject

Problems of Managing the Complexity of the System

Moderator

Professor Stanley S. Surrey
Harvard Law School

Discussion Leaders

The Honorable M. Carr Ferguson
Assistant Attorney General
(Tax Division)

Ward Hussey, Esquire
Legislative Counsel to the House of Representatives

The Honorable Jerome Kurtz
Commissioner of Internal Revenue

Stuart Seigel, Esquire
Chief Counsel
Internal Revenue Service

A premise of this session is that there are areas of complexity that cannot be removed from the taxing system. The speakers will discuss their various perspectives on the problems of managing the complexity that cannot be eliminated and the extent to which problems can be mitigated by effective administrative anticipation and organization. The value of regulations and rulings as possible instruments of simplification will be considered. Litigation policy and the impact of Justice Department participation in tax administration will be discussed. The effect of legislative drafting processes on the achievement of simplification objectives will be addressed.

Friday, January 6 (9:00 a.m. to 12:30 p.m.)

Subject

Simplification for Business Taxpayers

Moderators

Hugh Calkins, Esquire
Jones, Day, Reavis & Pogue
Cleveland, Ohio

Max E. Meyer, Esquire
Lord, Bissell & Brook
Chicago, Illinois

Discussion Leaders

Meade Emory, Esquire
LeSourd, Patten, Fleming, Hartung & Emory
Seattle, Washington

Howard Krane, Esquire
Kirkland & Ellis
Chicago, Illinois

J. Fred Kubik, C.P.A.
F. B. Kubik and Company
Wichita, Kansas

John R. Lindquist, Esquire
McDermott, Will & Emery
Chicago, Illinois

Professor John O'Byrne
University of Georgia
School of Law

Professor William P. Streng
Southern Methodist University
School of Law

Professor Alvin C. Warren
University of Pennsylvania
Law School

Commentators

Professor Charles E. McLure
National Bureau of Economic Research
Cambridge, Massachusetts

Rick Koffey, Esquire
U.S. Treasury Department

This session will be divided into three segments. Each segment will focus on different areas of concern for business taxpayers contemplating the possible effects of simplification.

The initial segment will be devoted to problems that may be peculiar to small businessmen. **Professor Streng** will provide a general statement of the effect of complexity on small business. **Professor O'Byrne** will discuss the impact of simplification proposals on smaller business units in agriculture as an example of specific problems that are likely to arise. **Meade Emory**, who has recently served as Special Assistant to the Commissioner of Internal Revenue, will comment on the presentations from the perspective of the Service.

The second segment will be devoted to some typical problems of complexity for ongoing businesses. **J. Fred Kubik** will discuss the impact on small businessmen particularly of complexities in the treatment of inventories. The presentation will include an analysis of the impact of inventory practices on the accuracy of income determination, Internal Revenue Service enforcement regarding inventory practices, and proposals to simplify LIFO reporting requirements. **Howard Krane** will discuss impediments to simplification arising from depreciation practices, investment credits, problems of classifying expenditures as capital or current, treatment of repaid deductions, and the possibility of safe havens to reduce disputes about certain deductions. **John Lindquist** will discuss the peculiar range of complexity created by ERISA, possible ways of dealing with the complexity, and methods of achieving ERISA objectives with a more simplified structure. **Meade Emory** will again comment from the Service perspective.

The third segment of the session will be devoted to a discussion of proposals to integrate the corporate and personal income tax systems. **Professor Warren** will discuss the theoretical aspects of integration and review proposals for integration that have been suggested. **Charles E. McClure** will comment on the economic effects of integration. **Rick Koffey** will comment from the Treasury perspective.

Friday, January 6 (2:00 p.m. to 3:30 p.m.)

Subject

Effect on Simplification of Relationship Among Federal and State and Local Income Tax Systems

Moderator

John H. Hall, Esquire
Latham & Watkins
Los Angeles, California

Discussion Leaders

Dale S. Collinson, Esquire
Wilkie, Farr and Gallagher
New York, New York

Daniel G. Smith
Director of Taxation
Wisconsin Department of Taxation

Professor Otto G. Stolz
Duke University Law School

This session will be devoted to an examination of the impediments to simplification arising from relationships between the federal tax system and state and local taxing systems. The panel will consider the impact of correlation between federal and state taxing laws, including the "piggy-backing" of federal returns for state filings. The use of the federal collection mechanism to collect state taxes will also be discussed.

Friday, January 6 (4:00 p.m. to 5:30 p.m.)

Subject

The Political Process of Achieving Simplification

Moderator

John S. Nolan, Esquire
Miller & Chevalier
Washington, D.C.

Discussion Leaders

Professor Paul R. McDaniel
Boston College Law School

Bernard M. Shapiro
Chief of Staff
Joint Committee on Taxation
United States Congress

The panel will discuss the political aspects of achieving simplification objectives. Factors impeding simplification will be identified and analyzed. The effect of input by different governmental institutions on the legislative process will be considered. The consequences of using the taxing mechanism to achieve numerous and varied social and economic objectives will be discussed. Prospects and proposals for revision of the political process, including the possibility of an independent commission to assist the Treasury and Congress, will be reviewed.

Friday, January 6 (7:30 p.m. to 9:30 p.m.)

Conference participants will meet in small working groups to discuss particular aspects of simplification in which they are experienced or interested. Different working groups will be organized to deal with each of the main areas discussed during the earlier sessions. The working groups will endeavor to formulate recommendations for presentation to the Conference as a whole on Saturday morning.

Saturday, January 7 (9:00 a.m. to 12:00 noon)

General Session: All moderators, discussion leaders, commentators and participants will meet to discuss the recommendations of the several groups and attempt to develop a summary of the views of the Conferees to be included in a report on the Conference that will be published and circulated to the public.

Appendix II

A Simplification for the Average Taxpayer

Deborah H. Schenk

The complexity in our tax laws, which has given rise to talk of simplification, is rooted in the statute itself. It is clearly the Internal Revenue Code and its progeny, the regulations, that are the sources of the difficulty. But the average American taxpayer [1] is either unaware of the statute or could care less. The man on the street is concerned with the complexity that manifests itself each year on April 15, when he tries to do his tax return.

Presumably then, simplification means those steps that would ease this annual burden. Most people seem to feel that simplification would be achieved if the average taxpayer could file his own return with little or no assistance with a minimum of difficulty.[2] Implicit is the assumption that it is wrong to ask people to pay to have their returns completed.[3] Therefore, Congress should do whatever is necessary to eliminate the need for the paid preparer.

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* Deborah H. Schenk is an Associate Professor of Law at Brooklyn Law School, Brooklyn, New York.

[1] The author has arbitrarily decided to use the term "average American taxpayer" to mean one whose adjusted gross income is less than $25,000. In 1975, 91.4 per cent of all returns filed had an adjusted gross income of less than $25,000. Internal Revenue Service Preliminary Statistics of Income 1975: Individual Income Tax Returns (1977).

[2] Wilbur Mills, then chairman of the House Ways and Means Committee, has said, "Simplification of the tax laws, of course, means different things to different people. In any major substantive tax reform action, however, the objective of simplifying the statute, simplifying the tax returns of taxpayers, and making easier the problems of taxpayer compliance should be high on the list of criteria." Mills. *Some Dimensions of Tax Reform,* 23 Ark. L. Rev. 159 (1969). The *New York Times* has editorialized, "[A] taxpayer with a high school education ought to be able to do his own return." April 5, 1977, at 32, col. 1. A former Commissioner of the IRS has said, "In our opinion it is wrong that the average American citizen who has a modest wage or salary and doesn't have large deductions to be itemized should have to pay anybody because it is so simple for him to do it himself." Commissioner Johnnie M. Walters, *quoted in* the N.Y. Times, March 18, 1973, at 23, col. 1. Testifying before the House Subcommittee on Oversight, Commissioner Donald Alexander agreed that the effect of simplification was that the average wage earner did not need to employ the services of a preparer. *Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 94th Cong., 1st Sess. (1975) [hereinafter cited as *Oversight Hearings*].

[3] *See* the statement of Rep. Charles Vanik, *Oversight Hearings, supra* note 2, at 125.

The thesis of this paper is that this goal, although laudable, is unachievable. To continue to imply that it is possible only exacerbates the problem. Even assuming this goal could be met, it would involve enormous trade-offs that most taxpayers probably would not be willing to accept. This is not to say that nothing can be done to ease matters. Some simplification is possible, and we should encourage Congress and the IRS to do so. Furthermore, simplification should be a factor—although not the determinant one—to be taken into account when new legislation is proposed or old laws reviewed.

But by and large, given our tax system with its inherent complexities, the average taxpayer will never be able to do his own return and probably should not even try.

This paper will examine what is complex for the average taxpayer and why it is so complex. It also summarizes possible ways to simplify and indicates that the inherent problems in simplification make it difficult to simplify enough to enable taxpayers to do their own returns. Finally, faced with that conclusion, it discusses what we should do.

WHAT IS SO COMPLEX?

For many taxpayers, complexity means the array of confusing forms and schedules.[4] They are convinced that they do not know what forms to use and that, even if they did, they could not properly complete them. Therefore, they simply do not try.[5]

Although it is true that the 1977 Forms 1040 and 1040A are simpler than ever before, they are still rather imposing. The taxpayer receiving the 1040 packet for 1977 in the mail got a two-page form, with over 70 lines calling for information, as well as nine different schedules. The 1040A Form is much simpler, of course, but the taxpayer must still figure out whether he is eligible to use this form.[6]

"There is an 'Alice in Wonderland' quality of speaking to a voluntary tax system, when nearly half of the Nation's taxpayers feel that they must get or pay others to help them complete their own returns."

[4] Woodworth, *Tax Simplification and the Tax Reform Act of 1969*, 34 Law & Contemp. Prob. 711 (1969).

[5] This attitude has been encountered often in the author's work with Community Tax Aid, Inc. (CTA) in New York City. This not-for-profit corporation prepares for free federal and state/city tax returns for low-income taxpayers in storefronts throughout the city. The attorney, accountant, and student volunteers prepare about 2,100 returns each year in seven locations for eight weeks. Income limits are scaled to the number of persons in the family, but generally $10,000 is the upper limit.

[6] In CTA's operations for 1977, approximately 80 per cent of the taxpayers used the short form. Preparers, however, had to ask a long list of questions before that determination could be made.

Undoubtedly, Form 1040 must contain a line for each possible item of income, each deduction, each credit, and so forth. Therefore, the form itself cannot be made substantially shorter. Most low- and middle-income taxpayers who are required to file a Form 1040 will do so for only one reason. They must, however, work their way through all 70 questions, most of which will probably not have any application to them.[7] Even though a particular line or schedule does not apply to a taxpayer, he has to know enough to know that it does not apply. Many taxpayers believe that they need professional help to figure out what forms, lines, or schedules apply to them.

A further complication is the fact that the forms often change from year to year, preventing many taxpayers from mastering them. This, however, is not necessarily bad. The 1977 Form 1040A, for example, is much simpler than the 1976 form and, if anything, may enable more taxpayers to handle their own returns.

Even assuming the taxpayer is not intimidated by the forms and wants to attempt his own return, he often gives up after attempting to follow the instructions.[8] The instructions accompanying the Form 1040 had 40 pages in 1976 and 47 pages in 1977, not counting the additional forms and schedules. Although the Commissioner's introduction says, "We believe the simpler form and instructions will make it easier for you to prepare your own return," it seems unlikely. The *Guide for Preparing a Return* has 19 steps. The basic instructions for the first page are six pages long. Length is not the only problem. They are clearly written by and for someone who has some understanding of the federal income tax. It seems improbable that the average low-income taxpayer who is not sure of his marital status or the number of dependents could figure it out correctly from the instructions. It has been alleged that a taxpayer must read at the level of a college graduate in order to comprehend the instructions for the forms for dividend and interest income and itemized deductions.[9] It is even questionable

[7] In 1977 20 per cent of the returns that CTA filed required a long form. The child care credit accounted for 13 per cent of the long forms, followed by interest on schedule B, 11 per cent; pension income, 6 per cent; rental income, 5.5 per cent; business income, 4.5 per cent; and itemized deductions, 3.5 per cent. Long forms also had to be filed because of IRA/Keogh contributions, social security tax, retirement income credit, dividends, alimony, capital gains, employee business expenses, disability income, contributions to candidates for public office, and self-employment income. In addition, 35 per cent of the long forms were New York state long forms, although a federal short form was used.

[8] In a 1974 survey conducted by the IRS, 80 per cent of the taxpayers indicated that simplified instructions would be very helpful. *Oversight Hearings, supra* note 2, at 121.

[9] *Hearings on H.R. 7590 Before the Subcomm. of the Comm. on Government Operations,* 92d Cong., 2d Sess. 251 (1972) (statement of William J. Emerson).

whether most college graduates not trained in tax can follow them.[10]

Much has been made of the fact that the number of taxpayers who do not have to file a return has risen dramatically over the last several years. In 1977, a married couple eligible to file jointly generally did not have to file if the adjusted gross income was less than $4,700. If the couple would be entitled to the earned income credit, however, a return would have to be filed anyway, since the credit would be refundable, even though there would be no tax liability. This raises yet another problem, since many taxpayers who do not understand or know about the earned income credit do not file a return when they should. Still, many people who do not need to file a return must seek out professional assistance to find that out.[11] The current commissioner has stated that, according to statistics compiled by the Department of Health, Education, and Welfare, the basic filing requirements were beyond the comprehension of a large portion of the adult population.[12] This is undoubtedly because the taxpayer must first figure out his filing status, his gross income or net earnings from self-employment, and his eligibility for the earned income credit *before* he can determine whether he must file a return.

For many taxpayers, complexity means definitional problems. Often they cannot and do not understand that certain items, such as scholarships and alimony, have a tax definition wholly apart from the common definition. Even if the taxpayer knows that there is a special tax definition, it is often uncertain or difficult to comprehend. For low-income taxpayers, marital status and dependency exemptions cause the most definitional problems. Odd though it may seem, many taxpayers are unaware of their proper marital status and whether they have dependents.[13] This is particularly true of low-income taxpayers, where spouses have separated or abandoned each other without a divorce decree, where parents are living together without the benefit of a marriage, or where family members pool funds to support each other. Furthermore, such terms as *head of the household* or *surviving spouse*, which only have a tax meaning, are particularly difficult to understand.

For many taxpayers, complexity means the long and complicated calculations that must be made in some instances. For example, the

[10] *See, e.g.*, Merz, *Honest Variations in Tax Returns*, 54 Taxes 82 (1976); Newsweek, Feb. 23, 1970, at 74; N.Y. Times, April 4, 1977, at 32, col. 1; Wall St. J., April 7, 1971, at 1, col. 4; all of which describe testing which indicates that this is so.

[11] In 1977, 4 per cent of the taxpayers visiting CTA offices did not need to file a return of any kind. Yet they often waited many hours simply to find that out.

[12] Address by Jerome Kurtz, at the Eleventh General Assembly of the Inter-American Center of Tax Administrators (May 9, 1977), *reprinted in* 123 Cong. Rec. S8349 (May 23, 1977).

[13] In 1977 approximately one-half the returns that CTA filled out had such problems.

exclusion for at least part of the gain on the sale of a residence by a taxpayer who is over age sixty-five requires a computation of basis, amount received, selling expenses, adjusted sales price, and a ratio.[14] The sick pay disability exclusion requires a phase-out computation.[15] These types of computations most often affect the middle-income taxpayer who is either unable or unwilling to handle them. The computations required for the exclusion of a portion of pension or annuity proceeds may eventually affect most working Americans due to the proliferation of pension plans.[16] Even low-income taxpayers using the short form have to make a rather complicated calculation to determine the earned income credit, which is in part based on *earned income,* a term that does not appear elsewhere on the return.

For many taxpayers, complexity means collecting and maintaining records in order to meet substantiation requirements.[17] For example, assuming a taxpayer meets the various tests applicable to itemized deductions, he will also have to retain the proper form of substantiation. And, of course, a taxpayer will have to maintain these records, even if he ultimately does not take the deduction due to applicable floors or the use of zero bracket amount, since in most cases the taxpayer will not know this until the end of the year or until he consults a tax preparer. In some cases, lack of documentation is a problem if the taxpayer is unaware of deductions.[18]

Taxpayers who rent part of their home are particularly affected by recordkeeping requirements and complex calculations. They must keep receipts for all expenditures and differentiate between rental and

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[14] I.R.C. § 121. This, of course, affects many middle-income taxpayers, particularly in nonurban areas.

[15] *Id.* § 105 (d).

[16] Several years ago the Treasury Department made a study of the accuracy with which recipients of a Federal Civil Service pension reported these amounts on their tax returns. The study found that 75 per cent of the tax returns reported these amounts improperly and that two-thirds of those reporting incorrectly had overstated their taxable income and paid too high a tax. Assistant Secretary of the Treasury, Edwin S. Cohen, mentioned this to a meeting of tax experts and commented that he doubted if a quarter of them could readily calculate the taxable portion of the pension received by a widow of an employee under a contributory pension plan. N.Y. Times, March 19, 1970, at 10, col. 1. Many taxpayers will receive a card from the company administering the pension fund that indicates the taxable portion of their year's payments. Others receive information concerning their contributions and previously tax-exempt payments. It has been the experience at CTA that taxpayers have no idea what to do with this information.

[17] In a 1974 survey conducted by the IRS, 63 per cent of the taxpayers with an adjusted gross income of under $25,000 said aids to simplify recordkeeping would be helpful. *Oversight Hearings, supra* note 2, at 120.

[18] The average taxpayer is aware of medical and interest deductions and has usually retained some form of documentary evidence. But many taxpayers are unaware of other possible deductions, such as union dues, professional expenses, investment expenses, or certain educational expenses, and have retained no documentation.

personal house expenses. In addition, they must compute a separate basis for the different portions of the house, as well as some fixtures, and must then calculate depreciation on each item. Homeowners in urban areas quite often have rental income, even though overall they are low-income taxpayers.[19]

For the average taxpayer, itemized deductions are the most complex recurring item. According to the Department of the Treasury, itemized deductions "cause the greatest complication in the individual tax."[20] This is undoubtedly due to the great number of deductions with their individual floors and ceilings and the overall comparison to the zero bracket amount. Most taxpayers, as a result, are unsure whether they should itemize deductions and cannot properly decide if it would be beneficial, without going through the tests and calculations of the deductions. And once the taxpayer decides to itemize, a large number of deductions are likely to be taken. In 1975 medical expenses were claimed on 19 million returns or 75 per cent of those that itemized.[21] Casualty losses were claimed on 1.765 million returns or 7 per cent of those filed by itemizers.[22] Gasoline taxes were claimed on 26.5 million returns, and charitable deductions claimed were on 24.6 million returns or about 95 per cent of those returns with itemizations.[23] Sales and income taxes are claimed on almost all returns using Schedule A. Although sales taxes appear to be simple, since nothing more than taking a number from a table is involved, most taxpayers have trouble doing so correctly, since the tables are based on receipts, a concept that involves adding certain tax-exempt items to adjusted gross income. Furthermore, if the state in which the taxpayer lives has local as well as state sales taxes, separate calculations have to be made. In addition, some itemized deductions involve rather complex calculations. The medical deductions, for example, require separate calculations for insurance, drugs, and all other medical expenses, as well as a comparison to a percentage of adjusted gross income.

The result, naturally enough, is that most taxpayers who think they have even a chance of itemizing turn to a professional.[24] Unfortunately, now that the zero bracket amount is so high, this includes a large number of taxpayers who ultimately will not itemize.

[19] In 1977, 1.1 per cent of the returns done by CTA had to include a Schedule E due to rental income. This percentage was much higher in some areas of the city.

[20] Department of the Treasury, Proposals for Tax Change 106 (1973).

[21] Joint Committee on Taxation, Issues in Simplification of the Income Tax Laws, 95th Cong., 2d Sess. 59 (1977).

[22] *Id.* at 61.

[23] *Id.* at 62.

[24] Many taxpayers who come to CTA year after year and who have never itemized deductions still retain receipts and ask if they should itemize.

The capital gains provisions have been said to be, perhaps, the single most complicating aspect of existing law. Although most low- and middle-income taxpayers do not have occasion to use these provisions regularly, when they do it becomes a nightmare. The complex definitional problems, as well as the interminable Section 1202, 1211, 1212, and 1213 calculations, evidenced in confusing forms, will sour the most optimistic taxpayer forever. It seems to be widely assumed that capital gains complexities belong to the high-income or unusual taxpayer. But many average taxpayers (and, in fact, most middle-income taxpayers) will at one time sell some stock or a residence and be forced to use these sections.

That the Internal Revenue Code, as seen in the forms and instructions, is indeed complex to the average taxpayer is shown by the high error rates and the large percentage of taxpayers using a paid preparer. In 1974 the percentage of taxpayers using a preparer was 61.3 per cent of taxpayers with incomes under $2,500, 69.3 per cent of those with incomes of $2,500 to $4,999, 66 per cent of those with incomes of $5,000 to $9,999, 59 per cent of those with incomes of $10,000 to $14,999, and 59.3 per cent of those with incomes of $15,000 to $19,999.[25] In 1972 47 per cent of those filing returns used commercial preparers and averaged $16 in fees, although they ranged from $3 to several thousand.[26] These figures are somewhat misleading, for the IRS is only able to compile statistics for those returns that a paid preparer actually signs. There are therefore no figures available for those returns prepared for free by a relative or a friend. And these numbers do not include the number of returns prepared by the IRS itself.[27] It seems fair to say that the vast majority of average American taxpayers do not do their returns single-handedly.

There are also reasonably high error rates, indicating difficulty in filing the return. According to the Annual Report of the Commissioner of the Internal Revenue Service, 8.8 per cent of the returns filed in 1976 had mathematical errors. The reports show that the number of such errors dramatically increases after major tax reform legislation. There are also persistent errors in the computation of items affecting the majority of low- and middle-income taxpayers. For example, 11 per cent of those who used the earned income credit made a computation error.[28]

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25 DEPARTMENT OF THE TREASURY, INTERNAL REVENUE SERVICE, REPORTING CHARACTERISTICS TAX YEAR 1974, 18 (1977).

26 N.Y. Times, March 18, 1973, at 23, col. 1.

27 The IRS prepares simple returns in taxpayer assistance offices and also completes returns mailed in with a minimum of information.

28 JOINT COMMITTEE ON TAXATION, ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS, 95th Cong., 2d Sess. 31 (1977).

The number of errors has become such a matter of concern for the IRS that it has been releasing data on errors to the media in midseason in the hope of improving the statistics.[29]

WHY IS IT COMPLEX?

There are many considerations that lead to the complexity of the Internal Revenue Code and thus the forms and instructions. We will deal here only with those reasons that affect provisions applicable to the average taxpayer.[30]

First, it is basic to a system of voluntary self-assessment that taxes be levied fairly; thus Congress has constantly sought to achieve greater equity. Generally there are two goals: vertical equity, which means that persons with larger incomes will pay greater amounts of tax, and horizontal equity, which means that persons with substantially the same amount of income will pay approximately the same amount of tax.[31] The search for vertical equity has resulted in progressive tax rates, while horizontal equity has produced the income-averaging provisions and the new carryover basis rules for inherited property, among others. Furthermore, Congress has attempted to correlate tax liability with ability to pay. The medical and casualty deductions, as well as different rates for each marital status, are examples of the ability-to-pay principle.

An equitable system, however, results in enormous complexity. It is difficult to specify when individuals are similarly situated and thus should pay the same tax. Tax practitioners have diligently carved out exceptions that have resulted in further legislative refinement. As inflation has raged, the ability-to-pay principle has been invoked to justify tax cuts through increased deductions, credits, and reduced rates.[32] Much of the recent criticism levied against the tax laws has been directed at the unfairness of a system that allows "high-income taxpayers" to pay little or no tax. Therefore, many reform provisions have been aimed at correcting this, although attempts have been made to increase the equity of the tax system at all income levels.[33] This kind of

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[29] *See, e.g.*, N.Y. Times, May 3, 1977, at 37, col. 2; *id.*, January 23, 1976, at 33, col. 1.

[30] For the causes of complexity in general, *see* Roberts, Friedman, Ginsburg, Louthan, Lubick, Young, & Zeitlin, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325 (1972); Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 Law & Contemp. Prob. 673 (1969).

[31] For further discussion, *see* R. Musgrave, The Theory of Public Finance, chs. 1-5 (1959).

[32] *See, e.g.*, Department of the Treasury, The President's 1978 Tax Program, (1978).

[33] H.R. Rep. No. 658, 94th Cong., 1st Sess. 7 (1975).

equity is not possible with a simple flat tax on gross wages, such as the social security tax.[34]

Second, the tax system has become complex because it has been used to promote and, occasionally, to achieve economic and social objectives through the use of tax incentives or disincentives.[35] The goals sought to be realized bear no relation whatsoever to revenue raising and are largely tax expenditures; that is, they result in a loss of revenue. Although tax expenditures are usually thought of as loopholes or as special privileges for the high-income taxpayer, the Code is replete with examples that affect the average taxpayer: credit for contributions to candidates for public office (participation in the political process); interest and real estate tax deductions (encouragement of home ownership); charitable deductions (philanthropic contributions); general tax credits (economic growth); exclusions for municipal bond interest (assistance to states and cities); deductions for state and city income taxes (coordination of local taxes); dividend exclusions (promotion of investment in corporate stock); exemptions for accident and health benefits (encouragement of employer-provided benefits); earned income credits (relief for social security tax on wages).

Recently, Congress and the President have increasingly turned to the tax system to enforce or to encourage compliance with national objectives. Consider the pending legislation to provide a credit for home insulation as a response to the energy crisis and the proposed college tuition credit to help middle-income parents.[36] This predisposition to use the tax system is natural, since it is already in "operation." No new agency is needed, and administrators and forms are easily provided. But, obviously, insufficient attention has been paid to the workload imposed on the Treasury and the IRS. Recently, Congress has been more cavalier than usual, adding such provisions at the last minute. As the 1978 tax season progressed, there was a possibility that an energy credit would be added. As a consequence, all forms and instructions had caveats that were certain to confuse the taxpayer. Even if the legislation were passed in time, how could the IRS possibly be expected to draft instructions that were correct *and* easily understandable at the eleventh hour?

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34 The Commissioner noted this recently in a speech in which he contrasted the income tax to the social security tax, which raises approximately half the revenues of the income tax with a minimum of technical problems and disputes. Jerome Kurtz, Tax Simplification: Some Observations from a Retrospective View of the United States Experience (May 9, 1977), *reprinted in* 123 CONG. REC. 8349-8352 (1977).

35 *See generally* Rice, *Tax Reform and Tax Incentives,* 34 LAW & CONTEMP. PROB. 673 (1969).

36 For an editorial critical of this approach, *see* N.Y. Times, Oct. 11, 1977, at 36, col. 1.

Those sections that offer tax incentives or inducements often are not only complex in themselves but cause proliferation. As taxpayers heavily utilize or abuse these sections, new sections are added to cut back on the benefits.[37]

Occasionally, Congress has also used the existing tax forms to elicit nontax information or to perform an administrative function. For example, the forms have contained questions pertaining to revenue sharing and foreign bank accounts. They have also been used for purposes unrelated to collection of the income tax, such as the Presidential Election Campaign Fund checkoff and the excess FICA tax refund.[38]

Complexity is also caused by the need to draw legislation carefully to fit a specific situation and no other. As a result, the section becomes long and detailed. This has happened not only to limit the application of a given provision but also to provide certainty in application. The taxpayer wishes to know with some certainty whether a given transaction is taxable or whether a given expense is deductible. In attempting to provide that certainty, Congress has often produced such overlapping and unorganized detail that a practitioner, much less a taxpayer, cannot give a certain answer. Unfortunately, that means that the average taxpayer simply cannot afford tax advice, since a reasonable fee for the time spent reaching an opinion is not commensurate with the advice sought.

The proliferation of credits (at the same time that itemized deductions have been limited) has been a major cause of increased complexity for the average taxpayer. First, since a credit provides the same benefit for low- and high-income taxpayers, recent credits have been made directly applicable to the average taxpayer.[39] Second, everyone is entitled to use credits, since there is no need to itemize, thereby requiring more taxpayers to determine qualification, make calculations, file a long form, and maintain records. Third, credits involve calculations because there are limits imposed. Fourth, except for the earned income credit, they are not refundable so that ordering rules must be set up.

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[37] *See, e.g.,* I.R.C. §§ 1245 and 1250, which limit depreciation, and I.R.C. § 170(e), which limits charitable contributions. By and large, however, the corrective sections do not affect low- and middle-income taxpayers. Ceilings and floors in the original section usually do affect the average taxpayer.

[38] Our experience in the CTA storefronts is that this type of information consistently confuses taxpayers, despite the fact that it has appeared for a number of years. Taxpayers invariably think these items are tied to their income tax liability.

[39] *See, e.g.,* the general tax credit, the earned income credit, the child care credit, the credit for the elderly, the credit for contributions to political candidates, and the phased-out credit for the purchase of a new residence.

PROBLEMS WITH SIMPLIFICATION

There is no doubt that simplifying the Code is a worthy goal. No one prefers complexity. Complexity is conducive to noncompliance; and in a system of voluntary self-assessment and compliance, that is a real danger. There are those who believe our tax system is in danger of breakdown [40] or that a taxpayer revolt is in the making.[41]

But if simplification means a tax system in which the average taxpayer is able to complete his own return, it is unlikely that the goal will be reached. The obstacles to be overcome and the trade-offs that must be accepted make that goal unattainable. There are problems that are inherent in any simplification proposal, and there are particular problems in the various suggestions that have been made to simplify the system.

First, the nature of our present tax system is inherently complex. Only a radical change in our method of levying taxes would remove certain obstacles. The intrinsically complex aspects of taxability include the graduated rates, timing problems due to annual collections, the concept of taxation on net income, identification of the proper taxpayer and source of income, and the taxing power of more than one jurisdiction.[42] These principles raise complex questions of when an item will be taxed, who will pay the tax, on what items a tax will be collected, and who can levy the tax. As a result, these inherent complexities, which face all taxpayers, put a severe limit on wholesale simplification.

Second, simplification as a goal is not as important as equity. Despite statements to the contrary,[43] it seems overly optimistic to suggest that we can easily have both. The crux of the problem is the degree of complexity we are willing to accept in exchange for increased equity. Even those who believe that simplification should take precedence realize that there is a trade-off involved.[44] Most Americans would probably

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[40] Roberts, *et al., supra* note 30, 27 Tax L. Rev. at 329.

[41] *See, e.g., Hearings on H.R. 7590 Before the Subcomm. of the Comm. on Government Operations*, 92d Cong., 2d Sess. 167 (1972).

[42] *See* Surrey, *The Problem of the Management of Tax Detail*, 34 Law & Contemp. Prob. 673 (1969); Joint Committee on Taxation, Issues in Simplification of the Income Tax Laws, 95th Cong., 2d Sess. 14 (1977); Panel Discussions on the Subject of Tax Reform, Committee on Ways and Means, 94th Cong., 1st Sess. 125-394 (1975).

[43] "It is essential for the nation's political and economic stability that the tax system be both simple and equitable, characteristics which are, of course, also desirable for their own sake." H.R. Rep. No. 658, 94th Cong., 1st Sess. 7 (1975).

[44] "We recognize that in a complex society and a complex economic system it is difficult —if not impossible—to achieve absolute equity without complication. However, considering the vast number of tax returns that must be prepared, processed, and audited annually, it may be necessary to sacrifice some of the complicating precision that has been provided to achieve equity and that affects so many taxpayers—to gain greater con-

prefer that the trade-off be in favor of equity, which is not surprising, since fairness has long been recognized as a basic tenet of our legal system. This does not mean that when equity requires varying treatment for different taxpayers or situations, the resulting provisions necessarily must be complex. There are undoubtedly instances when no tradeoff is involved. But generally, simplicity and equity cannot coexist.

One of the reasons that the average American would prefer equity to simplification is that he, like everyone else involved, has a vested interest in the present system. It is hard to believe that anyone would willingly give up an exclusion, deduction, or credit in order to simplify. In fact, a recent poll by the Roper Organization showed that the public is far more concerned about tax changes that would reduce tax bills than about simplifying the process. The researchers warned that the public would resist any tax change calling for ending or reducing deductions or increasing the types of income taxed.[45] Almost certainly, any attempt to simplify would adversely affect many taxpayers. Although any single change might only affect a small number of people, the number of changes needed to bring true simplification would, in the aggregate, affect nearly everyone. Of course, it is not only the taxpayers who have a vested interest in the current system. Industries, for example, that produce goods that are the subject of a tax expenditure would undoubtedly lobby against moves to eliminate the incentive. This kind of lobbying is usually effective with a Congress that generally supports such incentives. Consider the view of Senator Russell Long, Chairman of the Senate Finance Committee:

> [T]here's more to taxes than just putting more of a burden on somebody else's back. We've developed some techniques that we're pleased with where we can find ways to encourage people to buy new equipment, to build more plants, to hire more people. Our position in writing these revenue bills is offering us a chance just to do a great deal of good for the country.[46]

Closely related to the vested interest problem is the difficulty caused by reliance. Many taxpayers have entered into transactions or structured their affairs in reliance upon a tax incentive. In many cases, the transaction may not have been economically feasible without the tax benefit. The example affecting the most taxpayers is probably the home-

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venience in recordkeeping, tax reporting, review and follow-up." Statement of the Tax Division of AICPA, *reported in* 1973 Tax Advisor 196.

[45] N.Y. Times, July 27, 1977, at 12, col. 6. *See also* Cohen, *Remarks*, 25 Nat'l Tax J. 311 (1973).

[46] N.Y. Times, June 9, 1977, § D, at 1, col. 2.

owning incentive due to the deduction for taxes and interest. Although there are, of course, many cases where homes would have been purchased without the availability of deductions, there are also many cases where the homeowner could not carry the cost without the deductions. Repeal of these deductions would have an enormous impact on home ownership, the construction industry, and, possibly, some small financial institutions. Therefore, transition rules or grandfather clauses might be needed. Such an alternative, however, usually contributes to complexity, rather than alleviates it.[47] This short-term complexity may, however, be an acceptable price to pay in order to achieve long-term simplification.

To make these kinds of changes palatable, it has been suggested that they be accompanied by a reduction in tax rates. If, indeed, Congress is willing to support a rate reduction, as it presently appears to be,[48] then the rate reduction ought to accompany changes that will aid simplification. Unfortunately, however, reform or simplification proposals are often shelved, leaving only the tax cuts, which have more grass-roots popularity.

Finally, in weighing simplification against other worthy objectives, one should consider that although the goal of having a tax system where all can do their own returns may be met, it may be illusory. There is some question whether many taxpayers would do their own returns even if they could. Many taxpayers who could easily handle their own returns simply do not want to be bothered and consider the fee of a commercial preparer a small price to pay to avoid the April 15 ordeal.

Various proposals for simplification have problems not necessarily endemic to simplification in general. One of the most common proposals is either to eliminate itemized deductions (which raises the reliance and social questions noted above) or to raise the floor so that very few taxpayers itemize. It has been suggested by a number of Congressional committees, although never approved, that a floor for the total itemized deductions be added or, in the alternative, that a floor be added for those items not now having a floor (such as the interest deduction). In 1974 the House Ways and Means Committee proposed counteracting the resulting higher tax liability due to such a proposal by adding a simplification deduction to cover many small deductions.

Raising the zero bracket amount, along with eliminating the minimum and maximum standard deduction, obviously was a major step

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[47] *See, e.g.*, the unusually complex transition provisions accompanying I.R.C. § 1023, which changed the rules for the basis of property acquired from a decedent.

[48] N.Y. Times, Nov. 12, 1977.

toward simplification, since it further decreased the number of taxpayers who itemize.[49] The problem is that we must reduce not only the number of taxpayers using itemized deductions but also the number who have to keep records and compute deductions to see if itemizing is possible. Quite clearly, further increases in the zero bracket amount would further reduce the number of taxpayers who would even consider itemizing. Raising the zero bracket amount, however, may have an adverse revenue effect. Although the number of nonitemizing taxpayers increases as the zero bracket amount increases, the number of taxpayers deducting a larger amount than they would have deducted had they itemized will also increase. We will therefore undoubtedly reach a point where we will have to accept as satisfactory the percentage of taxpayers using itemized deductions, as opposed to the zero bracket amount, or else provide for a mandatory standard deduction.

Furthermore, adding new limits or qualifications would make it simpler for people who would definitely not itemize; but it would make it more complex for people who do. Perhaps, however, that is a trade-off that is acceptable, since it benefits the vast majority of taxpayers.[50] In addition, adding further limits would presumably ease the audit burden of the Internal Revenue Service, which, in turn, should reduce the volume of litigation.

Eliminating the distinction between above-the-line and below-the-line deductions does not further simplification; it only changes the site of the complexity. Furthermore, changing a deduction to an adjustment to income would add complexity. It affects more taxpayers because there are no limitations, as there are for itemized deductions. The same is generally true for the increasing use of credits. The change of the child care deduction to a credit certainly added complexity for many more taxpayers, but it seems unlikely that those affected would prefer a deduction.

Proponents of a broader tax base with a corresponding rate reduction argue that this would vastly simplify the system. Proposals for a comprehensive tax base are based on the theory that there would be few exclusions or deductions, thereby greatly broadening the tax base to allow for across-the-board tax reductions.[51] Even assuming that such a proposal could ever be adopted, there would still be definitional prob-

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[49] It is estimated that the new zero bracket amount, effective on 1977 returns, will reduce the percentage of itemizers from approximately 31 to 24 per cent. Joint Committee on Taxation, Issues in Simplification of the Income Tax Laws, 95th Cong., 2d Sess. 58 (1977).

[50] *See* Bittker, *Tax Reform and Tax Simplification*, 29 U. Miami L. Rev. 1, 5 (1974), in which Professor Bittker takes this position generally.

[51] *See, e.g.*, Comprehensive Income Tax, (J. Pechman ed. 1977).

lems, since most proposals exclude some items, such as gifts, and allow some business deductions. The definition of the taxable unit creates a problem, since some propose retaining the current units while others suggest family units or taxing the consumer of the income.[52] A further complicating aspect of the comprehensive tax base proposal is that many more taxpayers would be required to file a return because presently nontaxable items, such as welfare and social security, would be part of the base. In addition, noncash items now exempted, such as fringe benefits, would be included, thus creating new and difficult valuation problems. Although a comprehensive income tax might indeed simplify the tax law, it is unlikely that such a system would enable many more people to do their own tax returns, and it certainly would increase necessary recordkeeping. Furthermore, the adverse effect on simplification would be felt most by average taxpayers who would be the most unequipped to handle these recordkeeping and valuation problems.

It has also been suggested that some taxpayers could elect to use a form of the comprehensive tax base with lower tax rates as an inducement. In such a plan, most currently tax-free types of income would be included; and most nonbusiness deductions, as well as the zero bracket amount, would be eliminated. In return, lower rates would be available, depending on marital status. Generally, lower income taxpayers would not be included in such proposals, since, by and large, only middle- and high-income taxpayers would be using the applicable exclusions and deductions.[53] Such a proposal might be simpler for some taxpayers, but would only succeed in changing the kind of complexity for many. Most taxpayers with middle incomes would have to work out their taxes under both systems in order to determine which would be most beneficial. Elections, in general, breed two kinds of problems: (1) The taxpayer who knows about the election will be required to compute his taxes twice to determine the better method; (2) the taxpayer who does not know about or understand the election may be penalized by paying a higher tax liability than actually due.

Others have proposed that the exemption, which probably causes the most problems for low-income taxpayers, be converted into a credit on the ground that it would effect a simpler tax return, as well as a more equitable one.[54] It is hard to see how it would be simpler, although it surely would provide the same benefit to low- and high-income taxpay-

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[52] *See, e.g.*, McIntyre, & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573 (1977).

[53] *See, e.g.*, S 2780, 89th Cong., 2d Sess. (1965); Roberts, *et al.*, *supra* note 30, 27 TAX L. REV. at 375.

[54] N.Y. Times, Feb. 12, 1977, at 46, col. 1.

ers. The definitional problems, which are the source of the difficulty, would remain.[55]

SUMMARY AND CONCLUSIONS

Most proposals for simplification would, indeed, result in a marginally larger number of taxpayers able to do their own returns. But no proposal to date would result in the large-scale simplification that would allow most taxpayers to do their own returns. That objective is probably unachievable. But that should not deter those concerned about complexity from exploring any suggestions that would tend to make the system simpler. It is a worthy goal, even if seemingly unattainable.

At this point, the first step is to redirect our thinking to set a new goal. We can start by accepting the notion that, by and large, the average American taxpayer cannot understand the fine points of the law and cannot prepare his own return. Admittedly more difficult, we can agree that this is not a disgraceful or untenable situation, so long as there exists a competent cadre of preparers and practitioners who understand the law, can advise the average taxpayer, and can prepare his return for a reasonable fee. If our tax system is as complicated as it appears to be, then the average taxpayer should not attempt to handle it without special training, since, for the most part, his lack of experience will only work to his own detriment. We should not only recognize that the average taxpayer will have to turn to a preparer but also that he should be encouraged to do so. Accordingly, the Commissioner should stop telling taxpayers that they can do their own returns. To continue to imply that we can develop a return that the average taxpayer can complete only causes further irritation when the goal is not reached. Therefore, our attention should be directed to simplification for the preparer. Our goal should be to decrease or, at the very least, to maintain the level of complexity so that a relatively unsophisticated, but competent, tax preparer can understand the tax law. Such redirection automatically eliminates some problems. If a section or concept is too complex for the average taxpayer but can be mastered by the preparers, then simplifying need not be a concern. Although presumably anything that makes the system simpler for the taxpayer will make it simpler for the preparer, the reverse is not true. Consequently, we can set our sights much higher.[56] Complexity is indeed a pressing problem and simplification is needed, but it should be directed toward the average preparer.

[55] In our CTA storefronts, we have consistently found it difficult to determine who is a dependent. The support test, as well as the problems of children of separated parents, are common problems for low-income taxpayers.

[56] Undoubtedly, there are many taxpayers who are more intelligent or competent than

Congress, too, must focus on simplification in order to achieve the objective of an equitable tax law that is manageable by competent preparers. Unfortunately, Congress has acted in an *ad hoc* manner, enacting piecemeal revisions in response to revenue needs or election year pressures.

Congress must consider the effect on complexity of any new tax legislation and weigh the results in deciding whether to enact a given proposal. Congress should be satisfied that the new section(s) can be mastered by the typical preparer of those returns that will be affected.

The tax committees should also periodically review existing tax law, particularly laws widely thought to be complex for the majority of preparers. In such cases, the benefits of simplification should be weighed against the benefits of the present treatment. For example, it is hard to fathom a good policy reason for retaining the deduction for gasoline taxes. In fact, in light of the current energy crisis, it seems to thwart a national objective; and it would certainly aid simplicity to eliminate it. These committees should pay particular attention to tax expenditure provisions unrelated to revenue raising. The recent report of the Joint Committee on Taxation offers good suggestions concerning the questions that should be asked:

(a) What effect, if any, would continuation, repeal, or revision have on tax equity?

(b) Does the provision continue to promote desirable social or economic purposes?

(c) Is the tax incentive approach the most efficient method of achieving the desired objective?

(d) Would there be serious disruption of the economy if the provisions were repealed or significantly modified? [57]

This review of existing tax law should also be undertaken with an eye toward possible structural change. For example, inquiry should be made into whether current floors, ceilings, or limits are necessary, that is, do they actually prevent abuse or unintended benefits? Alternatively, are further limits needed to perhaps eliminate needless calculations for a large group of taxpayers? Some structural change for the average taxpayer is possible. For example, the new zero bracket amount eliminated three steps: the low-income allowance, the percentage standard deduction, and the maximum standard deduction. In particular, an effort

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some preparers, but they either prepare their own returns or turn to a more sophisticated advisor. By focusing on the preparer, we should not be satisfied with tailoring the law to incompetent preparers.

[57] JOINT COMMITTEE ON TAXATION, ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS, 95th Cong., 2d Sess. 43 (1977).

should be made to eliminate overlapping detail and the proliferation of sections by changing the original unworkable section, rather than adding a new corrective provision.

The IRS should be encouraged to continue its ongoing review of forms, schedules, and instructions, especially because it is at this level that complexity reaches the average taxpayer.[58] The forms for 1977, for example, were a vast improvement over the 1976 forms, since complex calculations for the standard deduction, exemptions, and the general tax credit are now part of the tables. As a result, it was estimated that 96 per cent of the individuals filing tax returns for 1977 would use the tables, rather than the rate schedules. The IRS should also review the various requirements that mandate use of the long form to see if, perhaps, the most common can be incorporated into the short form without endangering its simplicity. In examining the instructions, the IRS should evaluate whether they can indeed be written at a lower reading comprehension level; however, this should be attempted only if it can be done without any risk of misstating the law. It is important that the IRS make every attempt to give an accurate statement of the law in oral and written representations to the taxpayer. One cause of the current malaise is the often incorrect (and nonbinding) statements made by the IRS employees. Furthermore, if the instructions are aimed at preparers, rather than at the average taxpayer, then, perhaps, the reading comprehension level can be higher and misstatements will be less likely.

The Federal Paperwork Commission recently urged support for "piggybacking" state income taxes onto federal returns.[59] This would undoubtedly ease matters in jurisdictions with state or local taxes or both, but to date no state has taken the option. Not only do such taxpayers have to file several returns, but they are often handled in very different ways.[60] Preparers in multistate areas have such a plethora of forms to master that fees for preparing the returns are often prohibitive.

It should be noted that simpler forms and provisions should minimize the necessity of auditing. An audit, or, perhaps, merely the threat of an audit, is certainly a terrifying aspect of the tax system for a majority of taxpayers.

[58] Obviously, there is a point of diminishing returns, since the forms can only be as simple as the law. *See* Thrower, *Administrative Problems Due to the Tax Reform Act of 1969*, 1 Ind. Legal F. 41, 49 (1970). It seems doubtful that the Form 1040A can be made much simpler than the 1977 version.

[59] *Id.*, at 99.

[60] A New York City resident who worked in New Jersey in 1976 had to fill out a federal return, two New Jersey returns, a long form New York state/city return, and a New York credit return.

Some thought should be given to avoiding the capital gains nightmare for the average taxpayer, although real simplification is impossible short of repeal.[61] It is questionable whether preferential treatment, with all its complications, is proper for purely personal "capital assets." If items such as residences, vacation homes, and personal investment assets (for example, jewelry) were eliminated from the definition of capital asset, many Americans would never face the capital gains maze. Many more Americans would avoid problems if securities were treated as ordinary assets, but that would have greater economic repercussions. Perhaps we should experiment with limiting the types of assets subject to these provisions.[62] It seems probable, however, that put to a vote, most taxpayers would prefer complexity to loss of preferential treatment.

Finally, a law that really does nothing to simplify the process should not be called a Tax Simplification Act. In explaining laws or recommendations, the Treasury and Congress should not imply that a proposal adds to simplification when it clearly does not.[63] On the other hand, when a proposal would, in fact, have a major impact on simplicity, it should be noted by the Treasury and, perhaps, emphasized as an argument for passage.[64]

Admittedly, the focus can be on the preparer only if there are enough competent preparers and advisors. There are two possible sources: the government and the private sector. The government already has a large ongoing Taxpayer Assistance Program that handles telephone information requests and staffs branch offices, which provide advice and actually complete simple federal returns. It has been suggested that the IRS fill out all returns, with taxpayers possibly paying a minimal fee.[65] There are a number of problems with expanded IRS preparation. There are many situations in which the law is not clear and the tax treatment of an item is debatable. The IRS would be expected to take a position favorable to the government on these issues. Furthermore, the IRS can

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61 Partial simplification is possible. *See, e.g.*, President Carter's proposal to eliminate the alternative tax. DEPARTMENT OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM (Jan. 30, 1978).

62 This is a hobbyhorse, that is, only a theory, not a "tested path to an attainable goal." *See* Roberts, *et al.*, *supra* note 30, 27 TAX L. REV. at 370 n.122.

63 *See, e.g.*, the Carter administration's proposal to combine the exemption and general tax credit into a single credit. The Treasury report explaining the proposals notes that this "represents an important conceptual simplification." DEPARTMENT OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM (Jan. 30, 1978). Although the change may, in fact, be justified on equitable grounds, it certainly does little to simplify, since the confusion with exemptions is in the definition.

64 The President's proposal eliminating the itemized deduction for sales and gasoline taxes would aid simplification, and it is appropriate to discuss it in those terms. *See* the Tax Message sent by President Carter to Congress on Jan. 21, 1978.

65 *Oversight Hearings, supra* note 2, at 96.

be criticized for the quality of service it provides taxpayers. It has been estimated that the error rate may be as high as 25 per cent; [66] but that is probably no higher than the error rate for private preparers. Numerous surveys indicate that an identical problem that is submitted to a number of IRS offices often produces many different answers.[67] Finally, many taxpayers are simply unwilling to go to the government for assistance because they fear a breach of confidentiality, retribution, or bias.[68]

That leaves the commercial preparer industry.[69] Private preparers have also been criticized for poor performance. In many cases, preparers accepting fees have minimal or no specialized training. The result is incompetent preparation. Even worse, charges of unscrupulous and fraudulent practices have been levied. Testimony taken in 1972 on proposed regulation of commercial preparers was replete with examples of incompetent and fraudulent preparation.[70] In a 1973 survey, the IRS found that 16 per cent of the returns prepared by commercial preparers interviewed were incorrect but nonsuspect and that 22 per cent were potentially fraudulent.[71] Clearly, not all commercial preparers are dishonest or incompetent. But if we are going to focus on the preparer, then there must be a sufficient number of qualified and ethical preparers to shoulder the burden. This may have to involve further regulation, enforcement of present penalties, or additional training. Because of the difficulties in overseeing professional preparation, we will essentially have to assume commercial preparers are honest and competent. Thus substantial abuses cannot be tolerated.

CONCLUSIONS

There is probably nothing that can be done that will enable the majority of low-income taxpayers to prepare their returns without any assistance and retain any semblance of equity. By and large, they are simply unable to do so and should not be encouraged to complete a task that may only work to their own detriment.

[66] *Id.* at 131.

[67] *See, e.g.*, Wall St. J., April 13, 1972 at 1, col. 4.

[68] In a 1974 survey conducted by the IRS, of those who indicated they knew IRS taxpayer assistance was available but did not use it, 7.5 per cent said they would "rather get help from someone other than IRS." *Id.* at 94.

[69] Of course, there are services that provide free assistance in the preparation of returns. They are, however, currently able to handle only a very small percentage of taxpayers.

[70] *Regulation of Income Tax Return Preparers, Hearings Before a Subcommittee of the House Comm. on Government Operations*, 92d Cong., 2d Sess. (1972). *See also* N.Y. Times, Feb. 24, 1977, at 27, col. 1; Washington Star, April 9, 1972, at A1, col. 1.

[71] N.Y. Times, March 18, 1973, at 23, col. 1.

We should redirect our attention to simplification for the preparer. Our goal should be to decrease or, at least, to maintain the level of complexity that can be handled by a relatively unsophisticated tax preparer. If we are going to rely on preparers, then the law must never be so complex that preparers cannot manage it. Since the vast majority of taxpayers are in low- or middle-income brackets, they will be turning to generally unsophisticated advisors. Thus complexity must be satisfactorily limited so that the "average preparer," as opposed to the highly skilled lawyer, can master the system.

Secondly, the law must be manageable so preparers can charge a reasonable price.[72] Taxpayers will be willing to undertake professional assistance if the fee is commensurate with the rendered service. For low- and middle-income taxpayers, that means the fee must be a small percentage of the tax liability. It is important that there be a large pool of preparers in the private sector who can provide competent, nonfraudulent preparation services at a reasonable price.

As a taxpayer should not be penalized because the law is complex, we should explore the possibility of a government subsidy through a credit for the preparation fee. A credit would be preferable to the present deduction, since a taxpayer would not need to itemize and the benefit would be the same for low bracket taxpayers as for high bracket filers.[73] It would seem that a ceiling would be necessary to avoid escalating fees being subsidized by the government and to keep the credit in line with the ability-to-pay principle.

In the final analysis, then, we must gauge complexity by the preparer. We should stop trying to simplify so that the average taxpayer can complete his return. That is a losing battle. Rather, we should address ourselves to the following issues:

(1) Is the present law too complex for the average preparer, and if so, where can we simplify?

(2) Do we have enough preparers, and if not, how can we develop such a pool?

(3) Are our preparers sufficiently competent, and if not, how can we improve training?

Simplifying the tax law is, of course, a large undertaking, but we can make the task less formidable by directing our attention to the proper issues.

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[72] *See* Roberts, *et al.*, *supra* note 30, 27 Tax L. Rev. at 333.

[73] This would, of course, be a revenue drain because so many more taxpayers would take advantage of a credit, rather than a deduction, and because the government would also encourage them to use a preparer.

B

Overview: The Viewpoint of the Tax Lawyer

Sidney I. Roberts

My views on federal income tax simplification have been previously published under the title *A Report on Complexity and The Income Tax.*[1] Because this paper draws upon that report, a proper perspective may require an observation that this paper, and, indeed, this Conference, depart from the recommendation in our report. Our report recommended that the problem be considered by a commission. This Conference differs in three principal respects from the commission contemplated by our report:

First, our report expressly recommended the inclusion in such a commission of revenue agents and judges,[2] that is, those who administer and apply the law. None is included among the discussion leaders or commentators. That omission dramatizes a significant error in the development of the present tax system: the insulation of those who formulate and prescribe the law from those who administer and apply it.

Second, our report recommended that the commission have the benefit of a full-time staff.[3] This Conference enlists the part-time services of very busy people with full-time occupations.

Third, our report contemplated a study of several years. The report itself represented efforts over a two-year period, with monthly meetings devoted to review and revision of segments drafted between meetings. This Conference contemplates development of a consensus in four days.

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* Sidney I. Roberts is a member of Roberts & Holland, New York, New York.

1 [Editor's Note: *A Report on Complexity and the Income Tax,* submitted by the Committee on Tax Policy to the Executive Committee of the Tax Section of the New York State Bar Association and referred to throughout Mr. Roberts' presentation, was distributed with Mr. Roberts' paper to the Conference participants. The *Report* was reprinted in its entirety in 27 Tax L. Rev. 325 (1972), and 3 Tax Advisor 679, 724 (1972) [hereinafter cited as NYSBA Report].]

The Report reflects the views of the distinguished members of the Committee: Wilbur H. Friedman, Martin D. Ginsburg, Carter T. Louthan, Donald C. Lubick, Milton Young, and George E. Zeitlin; but also more importantly, it reflects the insights each of us gained from the others in the course of its preparation.

2 NYSBA Report, *supra* note 1, at 335.

3 *Id.*

THE TAX LAWYER'S DEFINITION OF COMPLEXITY

It would be salutary if the Conference forbade the use of the terms *complexity* and *simplicity*. These terms have too many meanings; barring their use would ensure that the discussion relates to the same subject at least at the same time. To the tax lawyer,[4] complexity means that:

(1) A reasonably certain conclusion cannot in some instances be determined despite diligent and expert research.

(2) A reasonably certain conclusion can be determined in other instances only after an expenditure that is excessive in time and dollars.

Our New York State Bar Report was entitled *A Report on Complexity and the Income Tax*. On reflection, the term *complexity* was not felicitous, and conversely, the tax lawyer's concern is not *simplification*. The first concern of the tax lawyer is certainty or predictability, that is, to know what the law is. His second concern is that this predictability (knowledge) be available at a reasonable cost. It surely should not be necessary to prove that a democratic system of government requires that its citizens ought to know the law they are required to obey.

A third factor of importance to tax lawyers should be added: The efforts of the Service to achieve compliance with the tax law are simply not commensurate with the law that is legislated. In short, to a considerable extent, the law that is legislated is simply not applied. The result is the "tax lottery," [5] discussed below.

THE IMPORTANCE OF THE PROBLEM

The chameleon terms *complexity* and *simplicity* obscure the significance of the tax lawyer's concerns because, as in the case of this conference and the recent *Joint Committee Staff Report*,[6] the problems of the low- and high-income taxpayers are treated togther. The numbers involved are so preponderantly at the lower end of the scale that complexity for the others is slighted. This, however, is a superficial response to a political factor; there are more voters among the low-income tax-

[4] For this purpose, the term includes a tax accountant who in practice performs the same services as the tax lawyer.

[5] NYSBA Report, *supra* note 1, at 329.

[6] Staff of the Joint Committee on Taxation, Issues in Simplification of the Income Tax Laws, 95th Cong., 1st Sess. (1977) [hereinafter cited as the Joint Comm. Staff Report].

payers. It is not a sophisticated recognition of the significance of the problem.

Noncompliance with the tax law by the small number of high-income taxpayers can profoundly affect the integrity of the tax system. The self-assessment system demands that the taxpayers retain some degree of confidence that they are paying no more than their fair share of the tax burden. The public's observance of the degree of compliance by the affluent minority affects their confidence in the fairness of the tax system.

Nor does the importance of the issue end with its impact on the collection of revenue. The general public forms its view of our entire system of justice less from the decisions of the Supreme Court of the United States than from their personal and direct contact with the law, as, for example, in traffic court and negligence actions. The tax system affects a large segment of the population very personally and directly. Their impression of the tax system is derived not only from its impact on them personally but also from what they hear and read about its impact on others. Thus the integrity of the tax system is more significant than the revenue it collects or fails to collect; our entire system of government is affected by a weakening of the public's perception of the tax system, including both the affluent minority who have direct contact with noncompliance and those who learn about it.

Moreover, the adverse impact of the unpredictability of the tax law is not limited to the wealthy. This misconception is shared by many. For example, in regard to the Tax Reform Act of 1969, Wilbur Mills has said, "[t]he complications of this legislation, for the most part, affect fairly sophisticated taxpayers with substantial income who are used to complexities and who have ready access to highly skilled tax counsel." [7] And Walter P. Reuther, in commenting on the minimum tax, has stated: "Let the tax experts employed by the wealthy work a little harder to figure the proper tax obligation of their clients rather than working hard to enable their clients to avoid their fair burden of tax obligations." [8]

This reflects a misconception concerning the level of taxpayers directly affected. The lack of predictability is not confined to the abstruse issues of "the wealthy," such as Subpart F, tax shelters, and reorganizations of publicly-held corporations. Taxpayers of more modest means are involved in issues of substantial unpredictability concern-

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7 Mills, *Tax Reform Act of 1969*, IND. LEGAL F. 26, 41 (1976).

8 *Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means,* 91st Cong., 1st Sess. Pt. 13, at 4604 (1969).

ing, for example, Subchapter S and Section 1244 (ironically designed for small business but spawning voluminous litigation); the sale of property for future payments, including the installment sale election; [9] recapture of depreciation; the investment credit; the organization and operation of a partnership and its incorporation; the deduction of traveling expenses; the taxability of meals furnished in an employee cafeteria; and so forth. Listen to the despair of a sophisticated tax lawyer in respect to one of these areas, a sale for future payments:

> Issues, at times as obscure as they are vital, escape the notice of the unsophisticated taxpayer, while the expert, perceiving them, invests disproportionate time and cost in search of a resolution and, too often finding none, must structure a commercially less advantageous transaction to achieve the desired result.[10]

Similarly, the owner of a modest business may require advice on the liquidation of a corporation under Section 333, the limitations of multiple tax benefits of controlled corporations (Sections 1561 *et seq.*) and the collapsible corporation provision (Section 341). Consider, with some sympathy, the taxpayers in *Aaron Cohen*,[11] who by an unwise election under Section 333 on a transaction involving a gain of about $290,000 (averaging $60,000 per taxpayer) paid deficiencies totaling almost $200,000.

For the tax lawyer, the most onerous interview with a prospective client is the one in which the tax lawyer must advise that, although the amount of tax asserted is a substantial part of the client's modest accumulation of wealth, the cost of "controversy" (that is, administrative proceedings before the District Conference and the Appellate Division and, in some cases, a Request of Technical Advice, as well as resort to the courts) is more than he can afford in light of the dollars of tax involved and the uncertainty of a favorable result. This cost would be reduced, and in some cases eliminated, if the tax lawyer were operating with a law affording a greater degree of predictability. He could then advise the prospective client that he had no case or that he had a very good case. If the former, he would advise the client to pay; if the latter, the cost of controversy would not involve an excessive cost in adminis-

[9] Ginsburg, *Taxing the Sale for Future Payment*, 30 Tax Rev. 469 (1975) (including an outline of the present law that requires over 100 pages, at 504-605); Ginsburg, *Taxing the Sale for Future Payments: A Proposal for Structural Reform and An Outline of the Present Law*, 27 U. So. Calif. Inst. on Fed. Tax. 1 (1975).

[10] Ginsburg, *supra* note 9, 30 Tax. L. Rev. at 475.

[11] 63 T.C. 527 (1975), *appeal dismissed* (2d Cir. 1975) (unpublished), *aff'd* (3d Cir. 1976) (unpublished).

trative proceedings, and the expense of the resort to the courts would be less likely.

The same embarrassing interview may occur in advising a client on a prospective transaction, perhaps in the one case in the client's lifetime when it is necessary to seek the advice of a tax lawyer. The tax lawyer should be in a position to advise without costly research, without the cost and delay in obtaining a ruling, and with less concern for the risk of the expensive cost of controversy.

Although the *Joint Committee Staff Report* refers to our *New York State Bar Report,* it does not include a reference to one significant statement made therein:

> This committee is unanimously of the view that the present course of development of the tax law, if not reversed, may well result in a breakdown of the self-assessment system. Indeed, some members believe that the breakdown has already occurred.[12]

The omission is symptomatic of the Staff's evaluation of the severity of the problem. The recent history of the tax law demonstrates that the Joint Staff is not alone in its failure to perceive that severity,[13] in part because Congress, many of the Treasury staff, and their academic advisors are substantially insulated from observation of the law in practice; in part, because they distrust the conclusions expressed by practitioners; and in part because of inadequate manpower, the difficulty of learning from the experience of others, and the difficulty of convincing anyone that a path that has been followed for many years is the wrong direction.

THE TAX LOTTERY

When a taxpayer encounters a doubtful issue in a proposed transaction or in a consummated transaction prior to preparation of his return, he is confronted with the tax lottery:

(1) Will his return be selected for audit?

(2) If so, will the agent be sufficiently skilled to discover the issue?

(3) If so, can the issue be resolved by paying less than the full tax on the basis of trial hazards?

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12 NYSBA Report, *supra* note 1, at 329-30.

13 Secretary of the Treasury George P. Schultz included the quotation in the text, however, adding: "We share that view." *Hearings Before the House Comm. on Ways and Means,* 93d Cong., 1st Sess. (1973).

(4) If not, will the government counsel make the telling contentions to the court?

(5) If so, will the court understand the issue?

Taxpayers do not ignore the tax lottery. Those more daring in resolving doubts in their favor surely fare better. The taxpayers in this group tend to merge with those of less conscience and morality. They separate the minimal doubt from the legitimate doubt and assert positions for which there is little or no basis. Finally, taxpayers succeeding in the tax lottery for the first time will inexorably be led to try it again, with less and less basis for a favorable position.

The tax lawyer confronts the tax lottery with ambivalence. Absent the risk of civil or criminal penalties, it is difficult for him to insist that his clients ignore the tax lottery and abide by a different set of rules than others. Nor would it matter if he did; his clients, and the clients' other professional advisors, are well aware of it and will either interpret the tax lawyer's advice in light of the tax lottery or seek other counsel more concerned with the interests of the client than with the integrity of the tax system. As a result, the practice of tax law descends, to a substantial extent, to an evaluation of the tax lottery, a game for which the tax lawyer has no taste and little skill.

The tax lawyer may piously refuse to consider the tax lottery. At least in respect to whether the revenue agent will discover the issue, he may refuse either to give his client the statistics on the small number of returns examined or to consider whether the particular doubt will be spotlighted on the income tax return. In some cases, he may even accurately assert that, like those who legislate, he does not have sufficient familiarity with the methods of examination and the skills of agents. This approach would require that the client seek another tax advisor who could evaluate the advice of the tax lawyer, with the latter's advice limited to what the result would be if the case came before a skilled judge after presentation by a skilled government counsel. The tax lawyer can hardly use the same device, however, to shield himself from evaluating the probabilities of settling the case in the Appellate Division or of succeeding in court.

Indeed, the tax lawyer is at a disadvantage in playing the tax lottery. His focus, developed by an intensive study of the tax law, is primarily on instances in which the taxpayer lost the tax lottery, rather than in those instances in which the taxpayer escaped. As a result, he expends an inordinate amount of time researching an esoteric point. Yet if he finds that a risk exists, the expenditure then may appear to be worthless if the risk in the tax lottery is small.

Even worse, the tax lawyer's learning and research may raise issues that a less sophisticated practitioner and, perhaps, the revenue agent will not see. The less sophisticated practitioner and his client have achieved the same result, while the client has avoided an excessive fee. This is an obvious advantage to the less sophisticated practitioner, since his fees may be lower but may include a larger profit content than those of the sophisticated advisor. The tax lottery does catch a few, but neither they nor those more lucky derive from their experience a deep respect for the tax system.

GRESHAM'S LAW OF TAX PRACTICE

Because of the present state of unpredictability in the tax law, the "bad" practitioners tend to drive out the "good" ones. This is, in part, the fault of the tax lottery, previously discussed.

Some commentators have recognized the restraint imposed by responsible lawyers in encouraging compliance by their clients.[14] The inadequacy of audits makes this a significant factor in maintaining the integrity of the tax system.

If tax lawyers are in a position to offer advice, with some degree of certainty, on the adverse tax consequences of a transaction, they can, in the case of an unconsummated transaction, discourage many clients from consummating a transaction that is contrary to the law and, in the case of a consummated transaction, generally convince their clients to report the transaction on their tax returns consistent with a reasonably certain interpretation of the law. If the law is not certain, the tax lawyer is often in a weaker position to accomplish compliance.

This denigration of the practice of tax law will also have an important effect on future generations of tax lawyers. Unless the present course of the tax law is reversed, should one encourage a law student to enter the field of tax law?

GREAT EXPECTATIONS

The tax lawyer's concern with predictability and simplicity differs from the concern of others in one significant respect: The tax lawyer does not have the unrealistic expectations of others who favor simplicity.

Although some tax lawyers might oppose reform that would dispense

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[14] Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail,* 34 LAW & CONTEMP. PROB. 673, 707 n.31 (1969).

with their services, a more mature view is that this concern is moot. The lessons of history should assuage any fears that the tax law will be so simplified as to adversely affect their livelihood.

It may be true that some tax lawyers, consciously or unconsciously, welcome the present state of unpredictability. This is implicit in the humorous characterization of a revenue act as an "Accountants and Lawyers Full Employment Act." It is also true that the current law may be productive of income for these lawyers whose principal function is to litigate or to obtain rulings or amendments of the Code or the Treasury Regulations for substantial clients. In addition, some tax lawyers can be, for the moment, captured by the interests of their client. On the other hand, even disregarding the public interest in a viable tax system, the view of these lawyers is shortsighted in their own self-interest. It overlooks the cost of research and controversy. Unpredictability increases costs; even lawyers are not such bad businessmen as to focus on increased volume and to overlook increased costs. And increased costs reduce volume by eliminating those who cannot afford those costs. Moreover, the denigration of the tax law affects all tax lawyers, including those engaged in controversy, as well as those performing an advisory function.

In any event, the simplification goal of the tax lawyer is more limited, and many thoughtful tax lawyers despair of attaining even this limited goal. The limited objective is to develop an income tax law that is determinable, predictable, and reasonably certain at a cost that is commensurate with the transaction involved.

Moreover, this limited goal is a worthy objective. Absolute justice for each member of our society may not be achievable, but that does not deter thoughtful and concerned citizens from seeking to achieve more justice. Can any serious student of the tax law assert that considerable improvement is not needed? Can he establish that a substantial effort has been made in that direction? Considering the minimal efforts that have been expended to date, is there any foundation for conceding futility at this time?

This limited objective should dispense with extended discussions of the reasons for complexity,[15] at least in the context of the tax lawyer's concern about the unpredictability of the tax law. Certainly, in balancing the competing interests of equity and the promotion of economic and social justice, predictability should not always be paramount. The tax lawyer's concern is that predictability has been too often disregarded, risking the continued viability of our tax system.

[15] *See* Joint Committee Staff Report, *supra* note 6, at 3.

The experience of the tax lawyer is that, to a considerable extent, the tax law as written is simply not observed. This cannot be established statistically by those not privy to the information available to the Treasury and the Service; it must be conceded that this is merely the impression gained by experience. This conclusion, however, is the implicit assumption of those tax lawyers who believe that the tax system will break down.

ROSEMARY'S BABY

One reason that others are reluctant to accept the tax lawyer's concern is that their conception is subconsciously affected by their identification with the existing law. Can one imagine a Congressman with long service on one of the tax-writing committees saying, "The tax law is a disgrace to the human race," or even providing an assessment made more accurate by elimination of political hyperbole. To a lesser but still considerable extent, this inhibition applies to government officials, present and past, who must bear the onus of blame if that assessment is accurate. The Service, represented by the Commissioner of Internal Revenue, faces a special inhibition. Its expression of such a view would not only reflect on its ability to cope; it might well encourage further noncompliance.

Tax lawyers, regardless of whether they accept responsibility for the existing state of the tax law, face similar inhibitions. They fear the direct consequences of confessing to their clients (or to themselves) that (1) they do not know the law, and (2) their clients would fare better if they had a less expert lawyer, preferably one with more flexibility concerning what transactions he would permit his client to undertake and whether and how to report a consummated transaction on his tax return.

The inhibitions are not always applied. A Secretary of the Treasury did agree with our assessment of the breakdown of the tax system. Robert Patrick, recently International Legal Counsel of the Treasury Department, in discussing the simplification of the taxation of foreign income and the potential impact of complex rules noted that "taxpayers will abandon the effort of conscientious compliance, and administrative agencies will be unable to cope with the details of the law or their responsibility to collect taxes." [16]

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[16] Patrick, *Simplifying the Taxation of Foreign Source Income,* 30 Nat'l Tax J. 321 (1977).

MANPOWER

The failure of compliance is not an accusation of incompetence or inefficiency on the part of the tax administrators. Manpower that is commensurate with the complexity of the law could avoid that failure. It is certainly doubtful, however, whether such a measure of manpower is achievable. Moreover, if the tax law were effectively and uniformly applied, it might well provoke a taxpayer's revolt that would dwarf those previously predicted, suggesting that the complexity of the present law is tolerated because the law is not enforced. The wide protest against the formulation of rules for the uniform taxation of "fringe benefits" supports this conclusion.

Nor should the Treasury and the Joint Staff accept culpability for statutory draftsmanship. The limitations of manpower and time are imposed by those who neither understand nor appreciate the problems of drafting or the problems of applying the law in practice.

A parallel situation emerges in the preparation of tax return forms. Criticism concerning the complexity of the forms is generally leveled at the Internal Revenue Service. Yet any thoughtful student of the tax law must observe with awe the extraordinary ability of those who compose the return form to accommodate the requirements of the tax law imposed by Congress.

SYMPTOMS OF BREAKDOWN

Whatever the reason, the tax administration is unable to provide a frank assessment of the failure of compliance. But indications of that failure are available to those who observe its application, especially tax lawyers who must seek to apply it.

A list of the indications of administrative breakdown must suffer from the impracticability of a complete catalogue. Moreover, it makes available to those who disagree the opportunity to focus their disagreement on the existence of the symptoms, thereby avoiding a discussion of the existence of the disease. Nevertheless, to convey the bases of the diagnosis, some symptoms must be listed.

The delay in the issuance of Treasury Regulations is prominent. The need for clarification of the statute, for both tax lawyers and revenue agents, ought to be axiomatic. Nevertheless, the list of untimely, delayed regulations is long and pervasive.[17] For example, at this writing,

[17] Report by Legislation and Regulations Division of IRS Office of Chief Counsel on Status as of September 30, 1977, of Regulations Projects, Daily Executive Report No. 200 (Oct. 14, 1977).

final regulations have not been issued under Section 83 of the Code, a provision enacted in 1969, or to reflect the substantial amendments to the personal holding provisions that were made in the 1964 Act and subsequent acts. As discussed more fully below, proposed regulations have not been issued under Section 385, relating to the characterization of debt as equity, as authorized by the 1976 Act. The Service announced in 1964 [18] that it would follow the *Coady* and *Marret* decisions to the extent that they hold that Treasury Regulation Section 1.355-1(a) is invalid. Proposed Regulations were not issued until 1977.

From the viewpoint of the tax lawyer, the list is incomplete in regard to other issues. For example, the Service and others have long been dissatisfied with Treasury Regulation Section 301.7701-3 in respect to the characterization of limited partnerships as associations, especially if the general partner is a corporation. To our knowledge, at least as early as September 1967, the Service has, from time to time, sought to begin a study in order to prepare for a revision of these regulations. Over this 10-year period of its dissatisfaction and inaction, the tax bar has been left uncertain as to the position of the Service, gleaning the limits of a safe harbor from Revenue Procedures, tax "gossip," and unpublished rulings. This decade of uncertainty, with its inefficient expenditure of time by both the Service and the tax bar, culminated in the *Larson* [19] and *Zuckman* [20] cases. The majority opinion in the *Larson* case reflected a concern for the need for predictability; nevertheless, four dissenting judges strained the provisions of the Treasury Regulations to arrive at the result they felt warranted, and one dissenting judge refused to be bound by the Treasury Regulations, although the Chief Counsel of the Internal Revenue Service expressly stated that the Service would not contend that the Regulations were invalid. In the balancing of equity and predictability, it is submitted that the dissenting judges failed to give due weight to the need for predictability by taxpayers and the tax bar during the 15-year period that the Regulations were outstanding. The Treasury must also be faulted, since it failed to reflect its entirely justifiable dissatisfaction with the existing Treasury Regulations by amending them.

Another illustration is Treasury Regulation Section 1.721-1(b)(1), relating to the receipt of a "profits interest" in a partnership. In the *Sol Diamond* case,[21] contradicting "a startling degree of unanimity" among commentators, the Commissioner argued, the tax court unanimously held, and the Fifth Circuit affirmed that the receipt of a "profits

18 Rev. Rul. 64-147, 1964-1 C.B. 136.

19 Philip G. Larson, 66 T.C. 159 (1976).

20 Zuckman v. United States, 524 F.2d 729, 36 AFTR 2d 75-6193 (Ct. Cl. 1975).

21 Diamond v. Commissioner, 74-1 U.S. TAX CAS. ¶9806 (5th Cir. 1974).

interest" was taxable. Recognizing the practical difficulties imposed by its conclusion, the circuit court stated: "We think, of course, that the resolution of these practical questions makes clearly desirable the promulgation of appropriate regulations to achieve a degree of certainty." More than three years after this beseeching, the list of the Legislation and Regulations Division, previously referred to, does not even indicate that a file has been opened on this issue. Meanwhile, private rulings expressly include a "no opinion" reservation [22] on the *Diamond* case. What are tax lawyers and revenue agents to do while the Treasury leaves this gaping vacuum? I suspect that, with occasional exceptions, they do what the Treasury does—nothing.

Certainly, the Treasury can plead a lack of manpower and the higher priority of other issues. But the vacuums in other issues are numerous. Business transactions must proceed. Taxpayers learn of these vacuums and apply them to their advantage. Revenue agents are left without guidance. The tax lottery continues.

Although affecting a smaller number of taxpayers, the status of Treasury Regulations under the tax conventions is another stark illustration. The issuance of Treasury Regulations has simply been abandoned, leaving outstanding those Treasury Regulations issued before the early amendments of the conventions. Instead, the Treasury promises that clarification will be accomplished by Technical Explanations in the legislative history of new conventions. This ignores the impracticability of gleaning from the legislative history of one convention the meaning of different terminology in others. This method also changes the administrative procedures required for regulations, in respect to both the officials responsible for their preparation and the opportunity for public comment. This anomaly of substituting legislative history for regulations is, perhaps, best illustrated by the oddity of the issuance of the release of "a proposed amendment" to the Technical Explanation of the pending tax convention between the United States and the United Kingdom, coupled with a request for comments on the proposed amendment.

Another symptom: the Technical Corrections Bill of 1977. The numerous errors in draftsmanship, from typographical to serious drafting errors, testimony to the haste in which the statute was drawn, provoked a statement by the chairman of the Senate Finance Committee that the Bill "is more than 100 pages long just to correct errors and oversights" in the Tax Reform Act of 1976.[23] The Bill portends that

[22] *See, e.g.*, 44 J. Tax 257 (1976).
[23] Daily Executive Report No. 205, at G-7 (Oct. 11, 1977).

errors of tax policy have also been overlooked, and it is hoped that these errors will be cured by regulations, rulings, judicial decisions, and legislation. Correction of errors after issuance in forms, rulings, and regulations similarly reflects the inability of the Service to cope with legislative complexity.

The impact of the lag between the tax lawyer's need to know and his actual knowledge is further illustrated by this issue: Is income realized on a transfer of property with an adjusted basis and fair market value less than the amount of the nonrecourse indebtedness to which the property is subject? A recent outline prepared for the New York University 36th Annual Institute on Federal Taxation[24] carefully tracks the tortuous history of footnote 37 of the *Crane* case,[25] decided in 1947, through 30 years of commentary written by some of the best minds in the tax area. The outline concludes that legislation is required to resolve the issue, a conclusion that was urged by Alvin Lurie 25 years earlier at the New York University Institute.[26] In sharp contrast with this 25-year history of scholarly but futile effort to provide a uniform law is the finding of the Staff of the Joint Committee as to what some taxpayers in the real world are doing:

> Likewise, if the partnership discontinues its operations, this should constitute a constructive distribution of the partnership asset (including, for this purpose, the unpaid portion of the nonrecourse note) to the partners, which in turn triggers the recapture rules of section 1245. However, it is by no means clear that all taxpayers follow sound tax accounting principles at this point in the shelter transaction, and much of this income may be "forgotten." When this occurs, it is difficult for the Internal Revenue Service to detect unless there is a field audit.[27]

Although tax lawyers and others have indicated concern over the functioning of the tax law by expressing agreement with our New York State Bar Association Report, that concern is also reflected in numerous articles written about various aspects of its operation. A complete catalogue is impractical; indeed, the plethora of articles alone is a reflection of the uncertainty of the tax law. A few illustrations, however, may be noted: John Nolan's article, *Audit Coverage and Private Tax Planning*,[28] recognizes that "the extraordinary complexity" of the tax

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[24] McGuire, *Tax Shelter Partnerships—Liabilities in Excess of Basis*, 36 N.Y.U. Inst. Fed. Tax. 1443 (1978).

[25] Crane v. Commissioner, 331 U.S. 1 (1947).

[26] Lurie, *Negative Equities and Negative Bases*, 10 N.Y.U. Inst. Fed. Tax. 71, 89 (1952).

[27] Staff of the Joint Committee on Internal Revenue Taxation, *Tax Shelter Investments*, in Tax Revision Issues—1976, No. 1, at 70 n.5 (1976).

[28] 27 Nat'l Tax J. 425 (1974).

law requires that concerned groups "must continue their relentless pressure to simplify our tax system" in order to remove areas "for tax planning opportunities and the consequent difficulties of the audit process." The article by James Rowen, *When May a Tax Lawyer Advise a Client that He May Take a Position on a Return,*[29] is not a primer on how far the tax lawyer may go in the interests of his clients, but rather is an expression of concern that because of the tax lottery "many aggressive taxpayers will ultimately pay substantially less than their share of the tax burden. Less aggressive taxpayers will pay more." Although a sale and leaseback has been a common form of real estate transaction at least since the early fifties, Ronald Morris' article, *Sale-Leaseback Transactions of Real Property,*[30] establishes that a simple issue of the proper method of reporting the amount of gain is not ascertainable, and a recent Revenue Ruling,[31] instead of at least clarifying the position of the Service, adds new confusion. A different but related issue, the characterization of a sale and leaseback as a mortgage, arises in numerous transactions, some litigated but more often not, but has been left for the Supreme Court [32] to resolve or, equally likely, to engender further uncertainty. Articles published on narrow issues too often express the tax lawyer's frustration, recently indicated by John Carroll:[33]

> I must admit that I was at first surprised to learn, as I looked into the subject of this paper how many of the questions it presents are not settled by reported court decisions. The fundamental concepts of the Internal Revenue Code as it stands in 1977 are those of the Revenue Act of 1924 though they have been elaborated at an ever-increasing pace throughout the intervening half century. Yet no one can point to authority standing squarely for the proposition that a common transaction done millions of times over during these years produces gross income or for the proposition that it does not.
>
> If the transaction were pitching pennies that might not be surprising, but the transaction (even in the mainstream form which everyone would be willing to call an "intercompany guaranty") has been the cornerstone of financings of the largest kind. Why do we not have authority for the root question? Is it because generations of tax legislators, tax judges, tax collectors, tax lawyers and tax accountants were all remiss in failing to see it, to raise it, and to deal with it? Or is it because there has been a large and enduring consensus on principle which has extended, though not in a fully

29 29 TAX LAW. 237 (1976).

30 30 TAX LAW. 701 (1977).

31 Rev. Rul. 77-413, 1977-2 C.B. 298.

32 Frank Lyon Co. v. United States, *cert. granted,* 429 U.S. 1089 (1977).

33 Carroll, *The Tax Consequences of Intercompany Guarantees,* 357 TAX F. 73-74 (1977).

articulated fashion, to something akin to the investment contract notion advanced here? The courts will, in due course, tell us what has been going on all about us.

THE DEFENSE OF UNPREDICTABILITY

One advertising ploy is to "sell" a defect. For example, there is this advertising legend: The manufacturer of a soap who could not eliminate an offensive smell resembling carbolic acid, hired an advertising agency that successfully sold the soap, unpleasant odor undiminished, on the basis that it eliminated "body odor," apparently offsetting one unpleasantness by another.

A casebook of well-deserved reputation lyrically states the case for unpredictability in its discussion of the judicial doctrines that, in disregard of the statute, bar tax avoidance schemes.[34] Referring to the reorganization provisions of the Code as "specific rules which chart a tax-free corridor through which may flow the corporate transactions intended to be so favored," the discussion continues:

> From the very beginning the courts, prompted by the Commissioner, have undertaken the task of policing this tax-free corridor. . . . As a consequence the literal language of the sections cannot be relied upon, and safe passage depends upon knowledge of the rules of the judicial gendarmerie. . . . Nor is the role of the judiciary confined to enforcing rules previously announced. Anyone applying for passage through the corridor runs the risk of *the judicial policeman inventing a new rule on the spot* if he thinks such action is demanded. And the Internal Revenue Service, in administering the statutory provisions, is alert to bring these situations before the courts. It must be remembered that most of the taxpayers who thus prompt administrative and judicial ingenuity have no real business in the corridor. But when such trespassers are in the throng, the barriers designed to separate them may catch an innocent, or may force the innocent to take added precautions to identify himself. The rules may also produce some uncertainty and confusion where the innocent too closely resembles a trespasser. Some have criticized the judicial vigilance on this score. Others believe that any effort to prescribe statutory rules covering all of the everyday transactions of the business world is bound to fail unless courts and administrators are able to cope with transactions that would otherwise involve a distorted application of those rules.

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[34] 2 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 633-34 (1973) (footnotes omitted) (emphasis added).

Although the quotation is a preface to a discussion of the reorganization provisions, the text later notes: "The principle of the [Gregory] decision [35] is not limited to the reorganization provisions, but pervades the entire Code. . . . It . . . indeed is basic to the interpretation of any tax statute."

The allegory is instructive. Unnoticed is the horror with which tax reformers would surely react to "a policeman inventing a new rule on the spot if he thinks such action is demanded," even if the offense were only a parking violation, much less a government exaction of a substantial portion of the taxpayer's earnings.

A similar tribute to the virtue of unpredictability involves the "inadequate capitalization" doctrine, for which the Congress, in 1969, urged the issuance of regulations to overcome the unpredictability of a morass of judicial opinions. Eight years later, no word has been heard from the Treasury. To heighten the suspense for taxpayers and their lawyers, the Treasury Department has not even acceded to a suggestion made in 1974 by the Tax Section of the New York State Bar Association that the Treasury announce that when (if?) the proposed regulations are issued, they will not be applied to obligations issued prior to issuance of the proposed regulations.

A defense of this inaction follows: [36]

> It is also worth noting that uncertainty may itself be desirable in some cases. Taxpayers, and particularly taxpayers' lawyers, like rules to be precise and certain because that permits them to go to the very edge of the rule with very little risk. But sometimes it is just as well if they stay a safe distance from the edge. Section 385 of the Code provides perhaps such an example.
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> As it stands [*i.e.,* without regulations] their lawyers make judgments, which is after all what they are paid for. And they must in practice make conservative judgments, because *non*-conservative judgments are usually what they get sued for. The result of the present uncertainty is that taxpayers create their own certainty by being conservative and overreaching is discouraged. That, it seems to me, is not a bad state of affairs.

This unabashed defense of uncertainty overlooks several points. Six years ago, a committee of the Tax Section of the New York State Bar Association, recognizing the need to achieve "a greater degree of certainty and uniformity," submitted suggestions for the issuance of Regu-

[35] Gregory v. Helvering, 293 U.S. 465 (1935).

[36] Hickman, *Federal Tax Regulations—The Need to Expedite and Simplify,* 30 NAT'L TAX J. 313, 314 (1975).

lations under Section 385.[37] These suggestions contemplated that the Regulations would expressly approve one area of indebtedness and expressly disapprove another area. The in-between area of uncertainty would permit those who would prefer the tax lottery to play the game. This approach was suggested as early as 1954 by the American Law Institute and was approved in principal by the American Bar Association and others.

A casual reading of Plumb's monumental article on the subject[38] should bar any contention that tax lawyers are paid for determining the law. Almost any position can be supported or defeated by selecting appropriately from among contradictory decisions. If reaching a conclusion from this morass is what tax lawyers are paid for, they are grossly underpaid for accepting an impossible task.

Nor do tax lawyers accept the responsibility for which they can be sued. Proper qualification of the lawyer's response, for example, "I don't know and nobody else in town can tell you,"[39] should bar any malpractice suit.

The frustration of others is in sharp contrast to the equanimity of those who defend uncertainty. William Plumb closes his 271-page article, previously referred to, with this comment:

> It is my conviction, however, that if a fraction of the time and energy that has been and will be devoted to distinguishing the indistinguishable, in countless litigated and audited cases and in the regulations-to-be, were directed instead to resolving the basic questions of tax policy, solutions would be found that would result in a sounder and more equitable system."

The frustration of tax lawyers is shared by judges, who are also confronted with this impossible task:

> There is no dearth of cases in this province of the tax law. So large is their number and disparate their facts that for every parallel found, a qualification hides in the thicket. At most they offer tentative clues to what is debt and what is equity for tax purposes. . . .[40]

This evaluation was supported by the Senate Finance Committee:

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37 Committee on Reorganization Problems, *Recommendations as to Federal Tax Distinction Between Corporate Stock and Indebtedness*, 25 Tax Law. 57 (1971).

38 Plumb, *Federal Income Tax Significance of Corporate Debt*, 26 Tax L. Rev. 369 (1944).

39 Biedenham Realty Co. v. United States, 509 F.2d 1171, 35 AFTR 2d 75-1019 at 75-1021 (5th Cir. 1975), quoting an earlier edition of Mertens' treatise in connection with another issue.

40 American Processing & Sales Co. v. United States, 371 F.2d 842, 848 (1967).

"The differing circumstances which characterize these situations, however, make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability."[41] At least equally significant is the plight of the silent revenue agents. How should they apply the "law"?

The realistic situation is even worse. Clients tend to press the tax lawyer beyond his "conservative judgment," often to the client's advantage, in reliance on the tax lottery. Moreover, is it sound tax policy to subsidize those taxpayers who dare to go beyond the course dictated by conservative judgment? Do we think that all, most, or even many of those who do not adopt the conservative judgment will be confronted with an adverse determination? Would not the tax lawyer be in a better position to counsel a conservative approach if there were some reasonable area of certainty not substantially more disadvantageous to his client than to those who choose to dare the uncharted area? Is it sound tax policy to have no rule of law and to leave the decision to the intuitive (that is, the irrational) individualistic, unpredictable judgment of a revenue agent, an Appellate Division conferee, or a judge? Does the tax lawyer's advice that there is no rule of law create a disrespect for the tax law or, at the very least, resentment toward it?

A NEW BANNER

One result of the issuance of our *Report on Complexity* is that it furnished a new banner for the tax reformer and the tax lobbyist. In part, because of the many meanings of complexity, it can be employed to buttress arguments for almost any position: the increase in the standard deduction; the taxation of capital gains as ordinary income; the elimination of the deferral of tax on foreign earnings or the elimination of Subpart F; the elimination of the Domestic International Sales Corporation (DISC) or the elimination of the incremental method for DISC; the carryover basis on death or the realization of income at death.

It was requested that this paper consider "the impact of the inclusion in the taxing system of tax expenditures. . . ." This permits a discussion of several points, previously made, which suggest that the issue of the inclusion of tax expenditures in the tax system cannot be resolved by focusing on simplification alone.

The first question in determining the inclusion, *vel non*, of tax

41 S. Rep. No. 91-552, 91st Cong., 1st Sess. 138 (1969).

expenditures cannot be resolved by observation of the tax system alone. Subsidy through the tax system must be compared with direct subsidy. This requires an analysis of the cost-effectiveness of the direct subsidy, a subject on which the tax lawyers have little talent or knowledge; nevertheless, they can hardly overlook it and focus only on the inefficiency of tax expenditures.

Moreover, focus on tax expenditures overlooks the strain placed on the tax system by social uses of the tax system that do not constitute a tax expenditure, but rather a negative tax expenditure. Certainly, in terms of complexity, especially in regard to the ability of the Service to achieve compliance, the boycott provisions are a match for DISC.

Third, a distinction must be drawn among tax expenditures. Solely on the ground of complexity, the deduction for interest on personal mortgages is not as complex as proposed limitations on that deduction, and the investment credit is not as complex as the limitations thereon.

Fourth, the tax expenditures, if preferable to a direct subsidy, apart from considerations of complexity, merely require an increase in manpower of the Service to achieve a degree of compliance commensurate with its increased burden. Just as the resources of the Service should not have been strained by adding to its burdens the policing of wage and price controls, the administrative burdens of tax expenditures should be matched by additional manpower. But complexity is only one factor, not the telling argument.

STATUTORY COMPLEXITY

The tax lawyer's problem with statutory complexity is not one problem but many. If statutory complexity requires close study, but the result of that study is a reasonably predictable conclusion, the tax lawyer will trade off the cost of that study for predictability, provided the statutory complexity is warranted by the policy to be achieved. For example, if the elaborate provisions of Section 305 are indeed necessary to close a loophole, the tax lawyer is prepared to accept the complexity of the Code and the Treasury Regulations; however, he cannot accept this complexity if the result is that in most cases of more than this one redemption, he will only be able to advise the client to seek a ruling.

Section 305 also illustrates the problem of compliance. Will revenue agents assigned to audit closely held corporations master the provisions of the Regulations? Will he notice the case of a prior redemption?

Is Section 305 intended only for large corporations or will it also be a trap for the unwary closely held corporation?

The Internal Revenue Code is, however, a badly drafted statute. Section 341 is the obvious illustration of a provision that defies reasonably predictable answers. This is largely because the Congress has added patchwork provisions, Ossa on Pelion, to circumscribe the excessively broad application of the Code prior to each amendment, rather than to reevaluate its policies and rewrite the statute.

Other provisions are traps more for the unsophisticated lawyer. For example, Section 336 provides only an exception for installment obligations; other exceptions are buried in Sections 1245, 1250, and 1248.

Among many provisions of the "Deadwood Bill," enacted in the Tax Reform Act of 1976, Section 269(c) illustrates an irritant for the sophisticated tax lawyer and a puzzlement for the less sophisticated practitioner. Enacted in 1954, this meaningless provision was not repealed until 1976, despite efforts of the Joint Committee Staff that began as early as 1970, with the introduction by Mr. Mills of H.R. 17971.

The Internal Revenue Code stands as evidence of many of the tax lawyer's conclusions about the Congressional approach to the tax law: its failure to keep in mind as a central, long range objective a symmetrical, simple structure,[42] its lack of research and time pressures;[43] its failure to make timely correction of errors;[44] and its addition of nontax objectives, without a commensurate addition of manpower.[45]

CONCLUSION

This paper must end where it began. It is a typically American weakness to assume that all problems can be readily solved, a product of another assumption, that all problems have a solution.

Our New York State Bar *Report on Complexity*[46] stated its general recommendations in these terms:

> As in the case of other social problems, no overnight panacea will solve a problem which has been festering and expanding for at least 30 years. Our modest recommendations include three major steps:
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> (1) Each group that plays a part in the formulation of tax legisla-

[42] NYSBA Report, *supra* note 1, at 339.
[43] *Id.* at 341.
[44] *Id.* at 342.
[45] *Id.* at 345.
[46] *Id.* at 334-36.

tion and administration must be concerned with the overwhelming evil of complexity and ambiguity and must exercise its role with continuing attention to that evil. It is the consensus of this committee that each group has seriously failed to assume its responsibilities and each of them must mend its ways.

(2) Because the present situation has grown to such an alarming point of crisis, a commission should be established, consisting of informed experts in all participating groups, which will seek to reverse the trend toward complexity. Members should not represent the groups from which they are drawn but should work together toward the common goal. The membership should not be confined to those who formulate the law; it should include those who actually administer and interpret the law: judges, officials in the Rulings Division of the Internal Revenue Service, revenue agents, and those who advise medium-sized as well as large taxpayers.

The commission should consider not only specific methods of avoiding complexity, but should address itself to the broad principles of tax legislation, for example: whether the statutory law is too specific, at least in some areas; the extent to which authority should be delegated by Congress to the Treasury; the responsibility for providing the need for more fundamental analysis of the basic premises; and indeed whether the entire mechanism of tax legislation needs a major revision.

In that connection we recommend the commission seek insight by a study in comparative law, to determine whether the tax systems of other highly industrialized countries have the same proportion of complexity in their tax systems and, if not, what pattern of their legislative and administrative process might be borrowed to improve our system.

(3) This report also includes specific proposals which it recommends for consideration by the commission: for example, the creation of a single line of jurisdiction in tax cases, including a court of tax appeals, enlarging the staff of the Joint Committee and the Treasury Department, more extensive utilization of tax practitioners for consultation, and a permanent agency to protect the comprehensibility of the tax system.

The committee resisted the temptation to make comprehensive and specific recommendations as to how the law could be made less complex, primarily on the ground that such recommendations would be both presumptuous and premature: presumptuous because the facilities and talents of this committee are meager indeed compared to those needed for the kind of study which it recommends for the commission; and premature because the effort would

> be fruitless unless and until it convinces the various groups that contribute to the legislative process of the existence of a crisis of complexity.

The last point in the quotation is the stumbling block to the solution. If this symposium can agree with the premise of our *Report* that continuation along the present path will "result in a breakdown of the self-assessment system," the participants will arrive at a consensus of measures that should be taken. On the other hand, if they cannot substantially agree with that premise, the participants will disagree with the suggestions for finding the right path. The principal difficulty is to convince those without daily experience in the application of the tax law of the gravity of the situation.

A sense of futility pervades the attitude of those tax lawyers who do evaluate the situation as grave because of the difficulty of proof. A bit of history, however, reinforces the intuitive conclusion of futility. For example, the report of the Twentieth Century Fund,[47] issued 40 years ago, a period exceeding the professional life-span of many of the participants in this symposium, stated:

> Whatever the cause or the remedy may be, the federal income tax is in danger, because a self-assessed tax such as the income tax is particularly dependent upon the active co-operation of almost all the taxpayers—in contrast, for example, with the customs duties, the tobacco tax, and the death duties. On the other hand, no evidence exists that the federal income tax is in any immediate peril of falling to the low level of the intangibles taxes levied at high rates by some states and localities, where the unfairness of both law and administration and the consequent resentment of taxpayers have admittedly made a joke of the tax.

The increasing uncertainty or complexity of the tax law that has occurred during this 40-year period, with no indication of a unified effort toward braking the descent, is certainly discouraging.

Earlier historical antecedent further exacerbates the tax lawyer's sense of futility. The Revenue Act of 1926 established the Joint Committee to investigate and report upon the administration of the federal system of taxation and upon any proposals or measures that "might be employed to simplify or improve the operation or administration" of the tax system. Consistent with our 1972 *Report on Complexity,* in 1925[48] Congress expressly recognized that "a large part of the difficulties in administration . . . obviously were due to

[47] Twentieth Century Fund, Facing the Tax Problem 349 (1937).

[48] S. Rep. No. 52, 69th Cong., 1st Sess. 1939-1 (Part 2) C.B. 322, 343 (1925).

the haste with which the Revenue Act of 1917 was necessarily drawn." Similarly, the House version of the 1926 Act provided for the establishment of a joint commission, of which one third would be members of the public. The Senate version, however, which eliminated public members, prevailed in conference.[49] The 1926 Act provision, currently Code Section 8022, states:

> It shall be the duty of the Joint Committee. . . .
>
> (2) *Simplification of the Law*
>
> (A) *Investigation of Methods.* To investigate measures and methods for the simplification of such taxes, particularly the income tax; and
>
> (B) *Publication of Proposals.* To publish, from time to time, for public examination and analysis proposed measures and methods for simplification of such taxes.
>
> (3) *Reports.*—To report, from time to time, to the Committee on Finance and the Committee on Ways and Means and, in its discretion, to the Senate or the House of Representatives or both the results of its investigations, together with such recommendations as it deems advisable.

Such a report was actually issued in 1927.[50] I do not know whether there have been subsequent reports, but the 1977 report of the Staff of the Joint Committee does not refer to any. In any event, Section 507 of the Tax Reform Act of 1977, in effect 50 years later as part of an Internal Revenue Code several times the size of the Revenue Act of 1926, requires the Joint Committee on Taxation to make a study regarding simplifying the federal tax laws and to submit a report before July 1, 1977, a date that has expired. The final sentence of the General Explanation [51] of Section 507 suggests a wry reading, obviously unintended, of its probable impact: "This provision will not have any revenue effect."

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[49] H. Rep. No. 356, 69th Cong., 1st Sess. 1939-1 (Part 2) C.B. 361, 382 (1926).

[50] Report of the Joint Committee on Internal Revenue Taxation, reprinted for the use of Committee on Ways and Means (1928).

[51] Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976 135 (1976).

C

Simplification and Comprehensive Tax Reform

Harvey Galper and Michael Kaufman

INTRODUCTION

In January 1977, the Treasury Department of the Ford Administration released its view of what tax reform could accomplish in a publication entitled *Blueprints for Basic Tax Reform.*[1] The purpose of that study was not to propose directly a legislative agenda but to present and discuss the basic structure of a tax system predicated on a comprehensive measure of income. The *Blueprints* exercise sought to determine the maximum potential for broadening the base of the tax system, thereby allowing a greatly reduced structure of tax rates. Base broadening does not involve the creation of additional income, for income is generated only as an outcome of economic transactions. Instead, base broadening results from the consistent application of rules for measuring income so that the income that is really "out there" can be made subject to tax.

The primary objectives of comprehensive tax reform are horizontal equity and efficiency. Horizontal equity, which requires that persons in equal economic circumstances be taxed the same, presupposes an accurate measurement of income in the first place. Efficiency, which calls for keeping to a minimum the distorting effects of taxes on economic decisions, also requires that income, as measured for tax purposes, should correspond to economic reality. Under such income measurement rules, resource allocation would be determined by economic rather than tax considerations. Comprehensive income tax

* Harvey Galper and Michael Kaufman are, respectively, Associate Director and Economist of the Office of Tax Analysis of the United States Treasury Department.

1 Department of the Treasury, Blueprints for Basic Tax Reform. (1977) [hereinafter cited as Blueprints]. Actually two model tax systems were developed in *Blueprints,* one based on a more comprehensive definition of income and one based on personal consumption, but for the purposes of this paper only the income tax model will be considered.

reform has long been advocated as necessary to achieve these two important goals.

The purpose of the present paper is not to evaluate the extent to which comprehensive tax reform, as developed in *Blueprints*, would achieve tax equity and efficiency, but rather to consider its impact on simplicity. The question to be addressed here is: Can a system that comprehensively taxes income also be a simpler tax system? This paper will evaluate the proposals in *Blueprints* in terms of the complexity that would be likely to result from their adoption. Although the basic proposals themselves will be discussed, the underlying rationale for each will only be mentioned briefly, as the equity and efficiency objectives that motivate them have already been noted.

Some preliminary observations are in order regarding the nature of the *Blueprints* study. First, although no claims have been made concerning the political acceptability of any of the recommendations in *Blueprints*, considerable effort was directed toward developing a system that would be administerable and workable in practice. Thus it was explicitly recognized that a tax system based on readily observable data will be inherently less complex. Hence *Blueprints* specifies that "transactions should be objectively observable—as in the case of the transaction of a wage payment. . . . 'Imputed' transactions, i.e., values arrived at by guesses or rules of thumb—as in the case of depreciation —should be kept to a minimum." [2] Thus realizations rather than accruals enter into the tax base, and specifically excluded are imputations for such items as the services provided by owner-occupied housing and in-kind benefits (*e.g.*, medical care). This cash or realization principle may at times come into conflict with comprehensive income measurement but at some gain in simplicity.

Second, the *Blueprints* study should not be regarded as definitive in the sense that all the decisions made are considered final decisions. In many cases, alternative recommendations are presented; for example, optional ways are presented for dealing with medical or charitable deductions and two transition rules are suggested for the phase-out of the preferential tax treatment for capital gains. If considerations of simplicity are found to be compelling, other alternatives could also be developed without doing violence to the principle of a comprehensive tax base. In determining whether the specific recommendations of *Blueprints* are compatible with simplicity, one should be aware of the fact that modifications to better achieve this objective are possible.

Third, there are some inherent limitations in examining *Blueprints*

[2] *Id.* at 42.

as a model tax system. Despite reasonably full articulation of specific proposals, many of the recommendations are spelled out only broadly and not in complete detail. Therefore, some difficulties will inevitably arise in comparing the complexities of current law, resulting from 60 years of experience with income taxation, with a set of more generally specified proposals for which the full array of rulings, regulations, and court cases does not exist.

Finally, one element of simplification often lost sight of in much of the discussion of complex forms and intricately structured transactions is whether the basic structure of the tax system itself is understandable. One important virtue of *Blueprints* is that it greatly clarifies what an income tax system should tax.

Our discussion of *Blueprints* will first describe the overall tax structure proposed and then consider in detail the taxation of corporate income, capital gains, business income generally, and retirement income. The results of the base-broadening measures envisioned by *Blueprints* are impressive. Using data representative of the year 1976, the study finds that for all tax filing units' comprehensive income, the tax base of *Blueprints* would have been $1,270 billion, compared to the adjusted gross income of $1,055 billion under 1976 tax law—an increase of 20 per cent.[3] Furthermore, income subject to tax, after taking into account allowable deductions and exemptions, would rise from $669 billion to $884 billion, an increase of about one third. Thus the potential for base broadening—and correspondingly for rate reduction—is large indeed. The specific proposals that would accomplish this expansion of the tax base are the main subject of this paper. First, however, it is necessary to discuss the topic of simplification itself.

WHAT IS MEANT BY SIMPLIFICATION?

To determine the degree of complexity inherent in comprehensive income taxation, it is necessary to identify the various participants

[3] Comprehensive income equals gross wages *minus* employee contributions to retirement plans and to old age and disability insurance *plus* fringe benefits in the form of employer contributions for life and health insurance (including Medicare) *plus* earnings in life insurance reserves and pension plan reserves *plus* self-employment income *plus* all dividends, interest, rents, and royalties *plus* inflation-adjusted realized capital gains *plus* undistributed corporate income *plus* unemployment compensation, retirement benefits, workmen's compensation, social security payments (excluding Medicare), veterans' benefits, scholarships and fellowships, welfare payments, the bonus value of food stamps, and black lung payments *plus* alimony received *minus* employee business expenses, alimony paid, state and local income taxes, and nonbusiness interest expenses. Child care expenses, up to a limit, are deductible in determining taxable income but not in defining comprehensive income.

involved in the annual struggles of taxpayers with the tax system. These participants include individual taxpayers—both those of moderate means and those with higher incomes and more complex transactions—corporate tax and financial officers, tax practitioners, and administrators and legislators of the tax system.

The average taxpayer often experiences considerable difficulty not only in assembling information and performing the calculations for preparing his tax return but also in interpreting the instructions required to fill out the forms. For instance, many middle-income taxpayers have trouble determining their eligibility for the retirement income credit or, in the case of divorced parents, the dependency exemption because of the rather complicated set of conditions governing the use of these provisions. For higher income individuals, the need to know the tax consequences of alternative investment and other transactions greatly complicates economic decisionmaking.

As in the case of individual taxpayers, corporate officers making investment or financing decisions are faced with uncertainties about how the tax laws will apply to transactions they are considering. Since many business decisions span a considerable period of time, corporate officers also need to make forecasts of possible changes in tax policy and administration that will affect the profitability of these decisions. Moreover, tax administrators may find it convenient to impose on corporations reporting requirements for annual statements of wages, interest, and dividends. Although these statements ease the burdens of recordkeeping for individuals and facilitate the monitoring of tax compliance by administrators, they, at the same time, impose additional complexity and costs on business managers.

Complexity in the tax code makes it difficult for tax practitioners to understand how the tax code applies to the problems of their clients. The disparity of tax treatments associated with alternative investments further complicates tax planning. As complexity escalates, more and more time of tax practitioners is spent in keeping abreast of tax developments and in counseling clients on the implications of these developments.

For tax administrators, tax complexity creates difficulties in providing taxpayers with intelligible tax forms, interpreting the tax code, enforcing tax compliance, and resolving legal disputes with respect to emerging tax issues. Complexity also increases the administrative costs of all these functions. Furthermore, legislators are becoming increasingly concerned about complexity, both in response to the complaints of their constituents and in their capacity as drafters of legislation designed to improve the equity and efficiency of the tax system. The

concerns of these various participants in the operation of a tax system must all be considered in evaluating the complexity of a proposed new tax structure.

Complexity is not a static concept that applies to a tax system for all time, but rather it characterizes the development of a system over time. Thus our current system not only *is* complex but it *has grown* complex in response to pressures created by its basic design features. An evaluation of the complexity of a tax system based on the *Blueprints* design should therefore consider its likely evolution, as well as its current features. This broader perspective may permit a more hopeful appraisal of the compatibility of simplification and comprehensive income tax reform. Several of the *Blueprints* reforms are very likely to lead to increased first-round complexity, but they would also greatly reduce the scope of transactions that are relatively lightly taxed. This virtual elimination of tax preferences in combination with a structure of lower tax rates would sharply diminish incentives to design transactions in order to receive special tax treatment.

Furthermore, experience has shown that tax-minimizing behavior on the part of individuals and corporations breeds further reaction by tax administrators and legislators who try to stem the tax avoidance tide by measures that specifically prohibit the latest tax maneuvers. Although the energy of tax reformers and administrators is large, the rewards for developing new tax gimmicks are likewise great. Thus unless the underlying cause of the tension is attacked directly, the prohibition of old shelters leads to the construction of new ones; and the tax system that emerges from this sequence of events may be more complex by far than what one might have expected from looking at the design of the system initially.

This kind of complexity may be called dynamic complexity. Much of the complexity in our existing code seems to be of the dynamic variety. The initial tension created by preferential taxation stimulates new types of transactions, as individuals seek to gain the tax benefits created by the preferences. This leads to reactions by administrators and legislators concerned with preserving the integrity of "legislative intent" and protecting tax revenues. A portion of the complexity of current tax law can undoubtedly be attributed to the complexity of modern society and to the efforts to use the tax system to serve diverse social purposes. But surely, a significant share must be attributable to this dynamic process. This process, in turn, has its roots in the economic pressures created by a failure to tax all income equally in the first instance.

Probably the leading example of the process of dynamic complexity

is provided by the special treatment accorded to capital gains. The preferential tax treatment of long-term capital gains has been generally recognized as one of the most significant sources of complexity in the code.[4] What most observers have in mind here, however, is the extremely complex set of statutory rules governing the taxation of capital gains and losses [5] and the definitional requirements that must be satisfied before the statutory rules on capital gains are even applicable. Dynamic complexity does not focus on these rules and requirements, complex as they may be, but rather on the economics of the initial tension between ordinary income and capital gains. For example, Professors Bittker and Eustice have observed: "One of the most persistent problems in the taxation of corporations and their shareholders . . . is the ordinary income-capital gain dichotomy in the field of corporate distributions." [6]

The problems arise because of the relatively favorable taxation of retained earnings vis-à-vis dividends. This distinction, Bittker and Eustice go on to state:

> [I]s a constant inducement to the accumulation of business or investment income in a corporation, where it will be shielded from a hostile tax collector. . . . [T]he tax collector has in turn been armed with statutory weapons to attack undistributed corporate earnings in the more blatant cases of tax avoidance. One weapon is the accumulated earnings tax, imposed by Section 531. . . . The other weapon is the personal holding tax imposed by Section 541 on the undistributed income of a "personal holding company". . . .[7]

This illustrates how attempts by taxpayers to reduce taxes by restructuring their transactions to increase corporate savings can provoke complex legislative responses. But despite these responses, "the use of the corporation as a temporary or permanent refuge from the graduated individual income tax is one of the principal landmarks of our tax landscape." [8]

Once resources have been accumulated in the corporation, pressure then is transmitted to the problem of how to get the money out. Several devices to accomplish this in a tax-minimizing way have been employed, including:

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[4] *See, e.g.*, Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 11 (1974); Surrey, *Complexity and the Management of Tax Detail*, 34 LAW & CONTEMP. PROB. 673-91 (1969).

[5] JOINT COMMITTEE ON TAXATION ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS 69-75 (1977).

[6] B. BITTKER & J. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS 5 (1971).

[7] *Id.* at 10.

[8] *Id.* at 15.

(1) Achieving income splitting and reducing corporate taxes by paying excess compensation in salary to family members of a corporation's owners (occurring mostly in the case of closely held corporations).

(2) Selling stock that has appreciated in value, when the appreciation is taxed at preferred rates.

(3) Entering into transactions that enable the shareholder to realize gains on corporate earnings without paying full taxes, such as redemptions of stock and partial and complete liquidations.

In each case, of course, the transactions must be carefully structured, giving rise to further complexity.

Also, at yet another stage in this dynamic process, the judicial system becomes involved. The preferential taxation of capital gains combined with the generality of the statutory definition of qualifying assets has forced the courts to decide whether various transactions qualify for capital gains treatment. Two examples where decades of decisions have failed to produce clear boundaries for capital gains treatment involve the taxation of payments for the termination of contract rights and sales of real estate by individuals. The ambiguity in the latter case stems from the fact that the capital gains asset definition excludes property held for sale to customers in the "ordinary" course of business. Thus preferential taxes on capital gains both in itself and in combination with corporate income taxation have been the source of a considerable amount of dynamic complexity.

Another illustration of dynamic complexity is reflected in the continuing efforts of tax legislators and administrators to control the use of tax shelters. Commissioner Kurtz, of the Internal Revenue Service, has aptly described this process in a recent address:

> Congress substantially curtailed many of the known tax shelters in the Tax Reform Act of 1976. But no sooner were the apparent leaks in the dike plugged than new ones appeared. . . . The fact that many of these transactions are extremely complex and present substantial administrative problems to the Service cannot be allowed to interfere with the fair administration of the tax laws. New laws may call for new responses. . . . We are making a concerted effort to learn of these new schemes as quickly as they develop and confront them as quickly as we can.[9]

After describing the work of the Service aimed at increasing the audits of returns showing income from tax shelters, Commissioner

[9] Remarks of Jerome Kurtz, Commissioner of the Internal Revenue Service at the 30th Annual Federal Tax Conference, U. Chi. L. Sch. (Oct. 26, 1977), issued by the Department of the Treasury, Public Affairs Division, Washington, D.C. (1977), at 1-4.

Kurtz discussed new revenue rulings that were about to be issued to curb the new types of tax shelter transactions that were "beginning to proliferate . . . in novel areas of investment."[10] In two cases, the rulings arose in response to taxpayers' attempts to circumvent the at-risk limitations of the 1976 Tax Reform Act, which were designed to limit taxpayers' losses to the amount of the assets they had personally risked in various ventures.

The basic problem in these cases is the tax-reducing possibility provided by sham transactions that overvalue assets and allow the purchaser excessive depreciation deductions. At-risk rules could be rationalized as one means of preventing sham transactions. These rules, however, could also prevent valid depreciation deductions from being taken for assets that were not artificially inflated in value when purchased. In practice, because accounting conventions often fail to measure income properly as it accrues, many legitimate loans might well have the appearance of sham transactions.

Apparently this tendency to overdo reform in an effort to restrict tax-reducing behavior has itself lead to further complexity in several cases. For example, Congress enacted the collapsible corporation provisions to prevent ordinary income from being taxed as capital gains in certain instances. But when it was realized that the collapsible corporation provisions had become so broad in scope that they were producing harsh and "unintended" results, Congress tried to soften them by enacting the extraordinarily complicated Section 341(e) to provide dispensations from the collapsible corporation treatment. Finding that the relief of Section 341(e) was insufficient, in 1964 Congress granted further relief in the form of Section 341(f), for which final regulations have yet to be issued.

Other examples could also be cited in which the failure to tax income equally has produced significant complexity. In each case, the taxpayer's initiative leads to subsequent reactions by administrators and legislators in a never-ending process. Therefore, for any proposed tax change, it is necessary to distinguish between first-round simplification and subsequent-round simplification. A proposal can be quite simple initially, but if it establishes pressure points that lead to restructured transactions and patchwork legislative remedies, further complex transactions will result. We might well be better off if we initially dealt with the problem in a fairly complex way but in a way that largely eliminated the tension.

It is against this background, then, that the complexity of a com-

10 *Id.* at 5.

prehensive tax system must be judged. Therefore, in reviewing the main elements of *Blueprints,* the following questions will be addressed:

(1) Is the proposed change a simplification?

(2) For whom is it a simplification?

(3) In what ways is it a simplification?

(4) Is it likely to be a lasting simplification?

(5) If there is more complexity, is the complexity such that it can be regarded as avoiding even more complexity farther down the road?

Finally, it must be recognized that there are inevitable problems of equity if major tax proposals are adopted immediately. Special transition rules are generally required to deal with these problems. Since these rules would complicate tax assessment activities, although only for the period of transition, they must also be considered in this discussion of tax complexity. Thus a final question is: Is it easy to move to the new tax system, or what are the problems of transition?

THE PROPOSALS IN *BLUEPRINTS*

This section will analyze the complexity of the tax system proposed in *Blueprints for Basic Tax Reform.* It will first consider the overall structure of the model comprehensive income tax and then consider the specific suggestions for taxing corporate income, capital gains, and deferred compensation of employees and for generally improving various income measurement rules. Recommendations for transitional rules will be reviewed for their impact on simplicity as well.

Overview of the Structure of *Blueprints*: Exclusions, Deductions, and Rates

The basic structure of comprehensive taxation, as presented in *Blueprints,* implements to a far greater degree than current law the principle of taxing income derived from whatever source. Also, and perhaps as a consequence, the overall logic of the model tax system would be much easier to understand. The tax base would embrace virtually all sources of income, including many items not now subject to the individual income tax, such as state and local bond interest, social security benefits, public assistance benefits, fellowships and scholarships, the bonus value of food stamps, unemployment compensation, disability and workmen's compensation, veterans' benefits, employer contributions to health and life insurance plans, earnings in pension

fund reserves, and corporate undistributed earnings. At the same time, the separate corporate tax would be abolished.

Taxing these currently excluded items, a decision based mainly on equity considerations, need not involve significant issues of complexity. State and local interest income would be treated the same as all other interest income. Similarly, taxation of benefits under various transfer programs, such as welfare or veterans' benefits, would only require the addition of a tax-reporting system to the current state or federal information system. Potential administrative problems that could arise from taxing in-kind benefits, such as public housing and Medicaid, are avoided by not attempting to include these items in the tax base. The bonus value of food stamps would be included because the cash equivalent value is readily determinable.

The main problem in the taxation of transfer payments, implementing a withholding system for such programs, is not addressed in *Blueprints.* If withholding is not instituted and recipients of such income have a final tax liability, they will be sorely pressed to pay at filing time. On the other hand, withholding can work a real hardship on those with very low incomes. A liberal system of filing for exemptions from tax would be required. One possible mitigating factor would be the fact that at the levels of most transfer programs, the amount withheld would be quite small due to the low tax rates at the bottom of the scale. And, of course, basic benefit levels could also be adjusted to compensate for their taxability.

The taxation of private and social security disability pay and unemployment compensation benefits gives rise to no additional complications. In these cases, *Blueprints* recommends that employer contributions would continue to be deductible, as under current law. Employee contributions to disability insurance, however, would also be deductible; and the benefits of such programs would be taxable.

In contrast, health and casualty insurance would be treated somewhat differently by *Blueprints.* In these cases, employer contributions would be treated the same way as private purchases of health insurance, with premiums paid out of after-tax dollars and proceeds not subject to tax. According to this logic, employer contributions to health and casualty insurance plans would be taken into taxable income by the employee. Similarly, payments for life insurance provided by the employer would be taken into income but not any proceeds paid under such policies. The calculations here would be straightforward and could readily be provided by the employer, as part of the annual wage statement to the employee. The only further complication occurs with

respect to whole life insurance, when the interest build-up in the insurance policy would also be subject to tax. A calculation of this interest could be easily made by life insurance companies that currently compute the cash surrender value of outstanding policies.

The exclusions from income, under current law, arising from retirement plans (including social security) and corporate retained earnings are discussed in more detail in other sections of this paper.

One implication of these proposals to tax current exclusions is that more individuals would be required to file tax returns than under current law. In fact, if simplification is measured by the number of returns filed or the number of taxable returns, comprehensive income taxation may be regarded as a step backward. Under current law, of the roughly 109 million filing units in 1976, only 87 million were required to file a tax return, and of this number only 66 million had a positive tax liability.[11] In contrast, the tax proposals in *Blueprints* would increase the number of taxable returns from 66 million to 81 million returns. On the surface, this seems like a regression on both equity and simplicity grounds. And yet *Blueprints* claims to replicate the current distribution of tax burdens. How can this be true?

The answer is that many returns now classified as nontaxable do, in fact, pay taxes; however, they pay them in an implicit rather than an explicit form. The best example is the corporate income tax, the burden of which may be allocated to all shareholders if not to all owners of capital assets. If this tax is allocated either to shareholders or to all capital income (the latter being the assumption used in *Blueprints*), then many "nontaxable" and even nonfiling returns are seen to be paying taxes, and often at very high rates relative to their incomes. In fact, if filing units with such implicit taxes are counted, the total number of "taxable" filing units under current law is 93 million, even though 22 million of these units file no tax returns.

Thus comprehensive income taxation in which the corporate income tax is formally abolished in favor of taxing corporate income directly to individuals may make these returns explicitly rather than implicitly taxable. This policy will not only achieve substantial gains in horizontal equity, but equally important, will facilitate an understanding of the idea that all income flows should be directly taxed to the individuals benefitting from them. Comprehensive income taxation, as defined in *Blueprints,* is more directed to obtaining an income tax code that really taxes income than to decreasing the number of tax

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[11] Another 3½ million returns received payments under the earned income credit provisions.

returns actually filed. Of course, any increase in the number of returns filed implies greater work loads and more resources devoted to tax administration.

Blueprints also permits a limited number of deductions in the determination of taxable income. Again, there may be a conflict between the more conventional view of simplicity and the *Blueprints* design. The conventional view holds that simplification results from fewer taxpayers itemizing deductions, rather than taking the standard deduction. The structure in *Blueprints* provides no choice between itemized and standard deductions. There is no standard deduction in *Blueprints*, but for purposes of income measurement, five deductions are allowed. These deductions are for employee business expenses; nonbusiness interest expenses; [12] state and local income taxes; alimony paid; and child care expenses, subject to certain limitations. The child care deduction would be equal to one half of actual child care expenses up to the lesser of $5,000 or the taxable earnings of the lesser earning spouse. In the case of employee business expenses, *Blueprints* also proposes a simplification option that would allow only those deductions in excess of a specified minimum amount.[13]

Although these deductions would generally be available to all taxpayers, many categories of deductions allowed under current law would be disallowed, such as state and local sales and gasoline taxes, property taxes for owner-occupied housing, charitable contributions, medical expenses, and casualty losses. Even moving expenses, now an "above-the-line" deduction, would be disallowed on the grounds that they, as with commuting expenses, are more in the nature of consumption outlays that reflect locational preferences, rather than job-related expenses.[14] These changes would simplify individual recordkeeping

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12 "Nonbusiness interest" includes home mortgage and consumer loan interest. Some economists have argued that these interest deductions should be disallowed in order to tax indirectly the implicit income derived from the ownership of consumer durables or housing that these loans are used to finance. Disallowance of these interest deductions, however, is not only a crude means of taxing this implicit income but also discrimination against those taxpayers that finance the purchase of homes and consumer durables by borrowing, as opposed to those who liquidate financial assets to make these purchases. In addition, disallowance of nonbusiness interest would create artificial incentives to substitute business debt for consumer debt. For these reasons, *Blueprints* would continue to allow nonbusiness interest deductions. Also although recognizing the existence of implicit income from owner-occupied housing and consumer durables, *Blueprints* would not attempt to tax this income primarily because of the adverse effect on simplicity of this kind of policy.

13 In the short run, this simplification option could be inequitable to employees for whom legitimate costs of earning income are no longer deductible. Over time, however, either wages would tend to rise relatively in those industries or employers would bear a larger share of the costs of earning income for their employees.

14 Arguments could be made about the merits of allowing most of these deductions. For example, some economists consider children a consumption good. Allowing the child-

and tax administration. Nonetheless, given the lack of a standard deduction choice, virtually every tax return filed would be an "itemizer." Thus *Blueprints*, from this perspective, may appear to represent a net increase in complexity.

In other respects, the recommendations in *Blueprints* would provide simplification by anyone's measure. Included here would be the abolition of the minimum tax, the maximum tax, and the whole range of credits now available under current law, such as the investment tax credit, the work incentive credit, the credit for contributions to candidates for public office, the general tax credit (which in itself involves a choice between two credits), the earned income credit, the child care credit, and the jobs tax credit.

The basic structure of rates and exemptions would also be simplified in *Blueprints*. As under current law, there would continue to be separate rate schedules for joint returns, single returns, and heads of households. The relationships among these schedules, however, would be very much changed. For example, the "marriage penalty," that is, the excess taxes that a joint return pays over two single returns for the same income, would generally, but not in every case, be reduced. The two factors contributing to this result are the structure of tax rates and the fact that a portion of the earnings of a second worker in the household would be excluded from the tax base. The exclusion would amount to 25 per cent of the secondary worker's income up to a maximum exclusion of $2,500. Also for secondary workers, a child care deduction, as already noted, would be allowed, rather than the current child care credit. These measures to improve equity among various types of taxpayers do not significantly complicate the tax code.

The schedule of tax rates would also be much simpler in *Blueprints*. For each schedule, there would be only three tax brackets. For the joint return, taxable income of less than $4,600 would be taxed at an eight per cent marginal rate, taxable income from $4,600 to $40,000 at a 25 per cent marginal rate, and income over $40,000 at a 38 per cent marginal rate. These rates, along with the structure of per-return and per-taxpayer exemptions, would yield about the same distribution of tax burdens by income class as does the combination of the personal and corporate income tax under current law.

The simplified nature of this exemption and rate structure stands in sharp contrast to current law, and this goes well beyond the issue

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care deduction could be viewed as lowering the costs of having children, just as the current moving expense deduction reduces the costs of moves that are primarily undertaken for "consumption" rather than for "business" purposes. BLUEPRINTS (at p. 7) recognizes, however, that the distinction between consumer and business expenses is not easy to make.

of tax computation. Under the proposed tax structure, most taxpayers would remain in a single marginal tax rate over most of their lives. Thus the new rate schedule could be described as a flat rate tax of 25 per cent, plus a positive surtax for high-income taxpayers and a negative surtax at the very low end. That this structure of rates comes quite close to the distribution of tax burdens under current law is due to the fact that under the model income tax in *Blueprints* relatively more income is included at the upper end of the income distribution. For example, whereas taxable income in the aggregate would be increased by 32 per cent, taxable income in classes over $50,000 would increase by almost 100 per cent.

Moreover, with this revised rate structure, calculations based on changes in marginal tax rates need not enter into individual financial planning. For example, the form in which to hold investments in retirement years as opposed to working years or whether to realize capital gains in one year as opposed to another would not be important considerations. This, in turn, would mean that income averaging would become less important, since the effects of volatility in income would not, in general, change the marginal rates at which income would be taxed. The proposed structure of tax rates could thus make a major contribution to a reduction in dynamic complexity.

Corporate Tax Reform

General Proposal. *Blueprints* recommends an end to the separate taxation of corporation income for reasons of equity and efficiency. On equity grounds, the rationale given is as follows:

> Strictly speaking, the uses concept of income—consumption plus change in net worth—is an attribute of individuals or families, not of business organizations. Corporations do not consume, nor do they have a standard of living. The term corporate income is shorthand for the contribution of the corporate entity to the income of its stockholders.[15]

The separate corporate tax may also have the undesirable economic effects of inhibiting the flow of savings to the corporate sector and discouraging the use of equity relative to debt finance. *Blueprints* would deal with the problems of both equity and efficiency by a form of partnership treatment, in which the income of corporate entities is directly attributed to the owners of the corporation and directly taxed under the personal income tax.

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[15] Blueprints, *supra* note 1, at 68.

This proposal for complete integration of corporate and personal taxes consists of five basic rules.

(1) The owner of each share of stock on the first day of the corporation's accounting year would be designated the shareholder of record.

(2) Each shareholder of record would add his share of the corporation's income to his own taxable income or deduct his share of the loss.

(3) Each shareholder annually would increase his stock basis by his share of corporate income or reduce it by his share of corporate loss.

(4) The shareholder's stock basis would be reduced by the amount of dividends he received each year. Once a shareholder's stock basis had been reduced to zero, the value of any further distributions would be included in income.

(5) Any difference between a shareholder's stock basis (adjusted for inflation, as discussed below, as well as for retained earnings) and the sales price he received for his stock would be added to his income and fully taxed when realized.

The implications for simplicity of the transitional phase-in rules for integration are considered below.

Although these rules address many of the technical problems inherent in integration, they are silent on others. The main advantage of these rules is that they approximate taxing to the shareholder corporate income as it accrues. Consider a shareholder who holds stock for an entire year during which time his share of corporate income is $100. Under the proposal, he would simply add the $100 to his taxable income. Dividends would have no current effect on his taxable income, but would merely reduce his basis.

What about the shareholder who owns the stock for less than a full year? Assume that the shareholder of record sells his stock, which has a basis of $1000, halfway through the year and that corporate income accrues equally over the year. In this case, he will have to add the entire $100 of corporate income to his taxable income, although only $50 of income accrued while he held the stock. The $50 of earnings will make the market value of his stock worth $50 more than his original basis. Under these conditions, at the middle of the year, he could receive $1,050 for his stock. As a result of the income attributable to him, however, his basis will rise to $1,100. The sale therefore results in a $50 loss that would be fully deductible. His taxable income at the end of the year would be $100+$1,050−$1,100 or $50, exactly what the corporation had earned as of the date of the sale. This is the identical result

that would obtain if the shareholder reported as his income the difference between his original basis and the sale price of his stock, an alternative calculation that *Blueprints* would also allow. In fact, this alternative treatment is probably preferable for part-year shareholders, since the corporation's income does not have to be known in order for the individual to calculate his tax.[16]

The shareholder-of-record designation is an important simplification of the integration proposal for public companies with large numbers of shareholders. This designation avoids the necessity of keeping records of precisely when the stock is sold during the year. Also this designation, in connection with the rules for basis adjustment, accurately measures the income of part-year shareholders, as indicated. The choice of the first day of the corporate year as the record date is needed to protect against trafficking in the stock of corporations that had incurred losses. If the final day of the corporate tax year were used as the record date, there would be a tendency for the stocks of corporations with losses to be transferred late in the year to higher income individuals for whom the losses would be worth more for tax purposes. Rules that encourage this behavior are undesirable in any tax system.

Integration would require corporations to report to all shareholders of record their share of corporate earnings. Shareholders would then add these earnings to their other income and would make three basis adjustments to their stock. The first would be an upward adjustment for corporate income attributed to them; the second would be a downward adjustment for dividends received; the third would be an upward adjustment for inflation. Shareholders would thus be faced with the not inconsequential problem of keeping track of the adjusted bases of their stocks over time. Although the information for making all of these adjustments could be provided by the corporation, these calculations would be required of all taxpayers receiving dividend income.

Audit adjustments under integration would be handled in the same way as under current law. All dealings would occur between the corporation and the IRS. The shareholders of record for the corporation's tax year in question would *not* be required to make up any tax deficiency, but the higher taxable income and tax liability would be associated with the stockholders of record in the year the audit adjust-

[16] An example may be helpful in explaining the equivalence between the two sets of rules for taxing corporate income to shareholders, even when corporate income, as measured at the corporate level, differs from market valuations of that income. Using the example of the text, suppose that the market values the corporate income halfway through the year at only \$30, rather than \$50. The shareholder's income by the alternative method discussed in the text would be \$30 = \$1,030 − \$1,000. By the first method, his income would be exactly the same, except this time the calculation would be \$30 = \$100 + \$1,030 − \$1,100 (adjusted basis).

ments would be settled. Similarly, under current law, an increase in corporate liability for any underpaid taxes affects the stock values of current stockholders. But, also as under current law, if an understatement of income is anticipated, the expected value of the tax deficiency will be reflected in the price that the affected shareholder paid for his stock in the first instance.

It might also be objected that the *Blueprints* system could place an undue hardship on low-income persons holding stock in companies that currently pay out few dividends. These individuals could be forced to sell their stock to pay their taxes. This liquidity problem could be solved by imposing a withholding tax on corporations and by granting a corresponding tax credit to shareholders of record for their share of the corporate withholding tax. The imposition of a withholding tax, however, would mean that a partial year shareholder would continue to have an interest in the corporation even after he sold his stock because the tax credit would not be transferable to the purchaser of the stock. In principle, the market should be able to handle this problem. Although the new buyer cannot purchase the credit, the seller would be willing to sell the stock for less if he expected a tax credit to be forthcoming.

Another set of issues raised by the integration proposal is the treatment of foreign source income and taxes and foreign shareholders of domestic corporations. Concerning the taxation of international income, *Blueprints* would favor the residence principle, under which all income wherever earned would be taxed according to the rules of the taxpayer's country of residence.

This, however, is regarded as a long-run objective. As an interim solution, *Blueprints* would continue to allow a foreign tax credit on foreign source income. The foreign tax credit would be computed at the corporate level and would be limited to 30 per cent, with the remainder of foreign taxes allowed as a deduction. Foreign source income of United States corporations would flow through directly to the parent corporations and their owners, whether or not distributed by the subsidiary or the parent.[17] It has been alleged that eliminating deferral would be a major source of complexity, but the earnings and profits of foreign subsidiaries must already be calculated according to United States tax-accounting rules in order to determine the deemed-paid foreign tax credit.[18] It may be that the most important administrative consideration would be the need for an expanded auditing and

[17] Foreign source income of corporations controlled by foreign shareholders would flow through to U.S. corporations and citizens only when dividend distributions were made.

[18] The deemed paid foreign tax credit for corporations is calculated by multiplying the ratio of dividends from foreign subsidies and earnings and profits of foreign subsidies by foreign taxes paid.

enforcement effort by the Internal Revenue Service to monitor, at an acceptable level, the calculation of foreign source income.

Blueprints thus deals with many problems associated with integrating the corporate and personal taxes. Other problems for which *Blueprints* offers no ready solutions might also be mentioned. There are, for example, income assessment problems stemming from interlocking corporate stock ownership and stock issues or redemptions after the record date. The rules enunciated by *Blueprints* would have to be extended to these situations before a workable integration plan could be achieved.

The problem with interlocking corporate stock ownership runs as follows. For two corporations owning stock in each other, the income of each must be determined simultaneously because one corporation cannot determine its income unless the other corporation's income is determined and vice versa. A completely accurate determination of the income of interlocking corporations requires the solution of a set of simultaneous equations. Any possible remedy for this problem is likely to represent a compromise between accurate income measurement and administrative feasibility.

Another problem on which *Blueprints* is silent but which may nonetheless have a bearing on simplicity is the question of how income would be attributed to stock newly issued during the year. To attribute all of income to original record date shareholders would be unfair to them, since part of the corporation's income clearly has accrued to the new shareholders. A related issue is how withholding tax credits would be divided among new and old shareholders. Additional rules for allocating corporate source income would be required, with obvious implications for complexity. The rules would also have to specify how income and withholding would be allocated to stockholders in the event of redemptions of stock by corporations.

Income tax analysts have expressed concern that integration could not readily deal with the problem of allocating investment tax credits and foreign tax credits to millions of shareholders.[19] This issue would not materialize under the *Blueprints* proposal. All credits except for the foreign tax credit would be eliminated, and the computation of the foreign tax credit would involve only the corporation and not its shareholders.

In general, full integration would unquestionably generate considerable complexity, although more for corporate management than for individual taxpayers. Approximately 15 million returns in the aggre-

[19] For example, Charles McLure raised this issue in discussions at a Brookings Institution Conference on Integration, held in October 1977.

gate would be affected, with 55 per cent of the returns from comprehensive income classes below $20,000. Even these figures do not reflect the effects of a possible increase in the ownership of corporate shares resulting from integration of corporate and personal taxes. Furthermore, some 2 million corporations would be required to change their accounting practices and procedures. Tax administrators, as a consequence, would have to step up their efforts to ensure that corporate source income and basis adjustments were correctly reported. On the other hand, by generally ending the advantage of preferred capital gains treatment for corporate retained earnings, the integration proposal would greatly reduce pressures to convert corporate income into capital gains. Full integration could thus have a favorable effect on dynamic complexity.

Transition Considerations. Perhaps the major transition issue in connection with the integration proposal is the taxation of undistributed income accumulated in corporations but not paid out prior to the effective date of integration. The other major transition consideration having a bearing on integration concerns how unused losses, deductions, and credits earned in prior years but not yet utilized because of limitations of one type or another would be taxed under the integration proposal.[20]

As an operating principle, *Blueprints* states that "to the maximum extent practicable, an attempt should be made to treat such items in a manner that reflects the impact of the corporate tax as in effect when the items were incurred or earned." [21] Rules to accomplish this objective would definitely complicate corporate taxation during the transition period, as well as decisions of managers and financial investors, since the existence and possibly changed status of the credits would alter the after-tax returns that could be expected from owning the stock of some corporations.

Capital Gains Tax Reforms

General Proposal. The basic recommendations of *Blueprints* for capital gains and losses are easily summarized. Gains from the sale of capital assets [22] would be fully taxed upon realization at ordinary rates after

[20] For example, a net operating loss carryback or carryover arises because the taxpayer's deductions exceed his gross income. Capital loss deductions are limited to capital gains, deductions for charitable contributions are limited to a certain percentage of income, and the investment tax credit is generally limited to 50 per cent of the tax otherwise due.

[21] BLUEPRINTS, *supra* note 1, at 197.

[22] Debt would not receive an inflationary basis adjustment because of an important

(1) adjustments to basis for corporate stock (as explained in the integration proposal) and (2) an adjustment to basis for general price inflation. Losses, after similar basis adjustments had been made, would be fully deductible. Losses would be limited, however, to the adjusted basis of the shareholder. At the time of death, capital gains would also be taxed as if fully realized. *Blueprints* would continue to allow rollover in certain situations, including business reorganizations and sales of principal residences.

The adjustment for inflation would be accomplished by multiplying the original basis of the asset (or the basis at the beginning of the taxable year in the case of corporate equity) by the ratio of the consumer price index in the year of purchase (or the beginning of the taxable year) to the same index in the year of sale (or the end of the taxable year). The ratios to apply would be provided in the form of a table that would accompany the capital gains tax schedule. No inflation adjustments would be provided for intra-year sales and purchases.

Blueprints recommends the above treatment on the grounds of equity, since changes in capital values that merely reflect inflation are not real income. It considers but rejects: (1) the full taxation of accrued capital gains on the grounds of difficulties of valuation and (2) an interest charge on the deferral of taxes resulting from the postponement of realizations on the grounds that such an approach would engender considerable complexity with only small gains in more accurate income measurement.

Adjusting for inflation would in itself complicate the calculation of income, but would not be expected to produce insuperable difficulties for tax practitioners, administrators, or accountants. Furthermore, these rules for taxing capital gains must be compared with the complexities of existing law. For example, under *Blueprints* there would be no need for recapture rules to prevent ordinary income created by excess depreciation deductions from being taxed as capital gains. Not only would better income measurement rules limit deferral but recapture would occur automatically, since all gains would be taxed in full.

Moreover, taxpayers would be spared the need to undertake the

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distinction between capital income in the form of contractual interest and income generated by other assets. In the latter case, inflation reduces the value of nominal depreciation deductions and capital gains and therefore results in a transfer of resources from private individuals to the government. Although inflation can also reduce the value of nominal interest payments, this causes a transfer of resources from creditors to debtors, rather than between creditors and the government. That is, the debtor's gain is the creditor's loss. Furthermore, if allowed to adjust, interest rates may increase in a way that can allow both parties to the loan transaction to offset the effects of inflation, which reduce the value of principal repayments.

present complicated netting procedures, whereby the gains and losses are divided into short- and long-term accounts, the net gain or loss in each account is determined separately, the resulting net figures in each account are netted against each other, and any net losses are subject to an income limitation but with an unlimited carryover. The alternative tax of 25 per cent on the first $50,000 of long term gains; the capital gains provisions in the minimum tax and the maximum tax; and the special capital gains treatment accorded timber, livestock, coal, and iron ore would be removed from the tax code. Taxing capital gains in full at death would also be far less complex than the carryover of bases rules provided in the 1976 Tax Reform Act.[23]

Removing the tendency of inflation to increase taxes on capital income would also reduce the continual pressures to effect relief through legislation—often, with uncertain or unintended side effects. This would not only contribute to a more stable tax environment for economic decisionmaking but also would give investors less reason to be concerned about restructuring transactions to compensate for both inflation and a tax base defined in nominal terms. Thus reducing the distinction between ordinary income and capital gains would abate the legislative and economic pressures toward dynamic complexity. The advantages of deferral, of course, would continue to be a factor in tax planning, but the range of assets to which deferral would apply would be severely restricted. This would be particularly true, since returns on corporate stock would be taxed largely on an accrual basis and improvements in the measurement of the income from other assets, as indicated below, would remove that source of capital gains under current law.

Although the information for making inflation adjustments could be readily provided, additional computations would be required of many taxpayers. In 1976, some 7½ million returns actually realized net long-term capital gains or losses, but this figure presumably understates the number of taxpayers holding assets for which basis adjustments would be needed. Moreover, if the pattern of realizations is indicative of the pattern of holdings, about one half of the tax returns affected would be in comprehensive income classes below $20,000.

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[23] The current carryover provisions cause great complexity for estate planning. For example, to minimize taxes, low-basis assets should be given to low-income heirs or to charities and high-basis assets should be given to high-income heirs. Full taxation of capital gains at death would also put a limit on the deferral of taxation on these gains. It may be objected that the proposals in *Blueprints* would allow gains to go unrecognized currently, whereas capital losses would be deductible when realized. Given the other income measurement rules and the integration proposal, the possibilities for manipulation do not loom sufficiently important that they could not be corrected.

Transition Considerations. As is the case with other proposals, *Blueprints* recommends transition rules for gains and losses that have accrued prior to the effective date of the new rules. These transition rules would deal with the equity problems that would otherwise arise from an immediate application of the new capital gains procedures.

Holders of existing capital assets would be allowed a 10-year period over which the old rules would phase out. The phase-out could take one of two forms. Under one procedure, the inclusion rates would increase over the 10-year period from 50 per cent to 100 per cent. An alternative transition procedure, which would probably be less disruptive of capital markets, would allow investors to treat realized gains or losses as accruing proportionately over the interval that the asset was held, with the portion of the gain attributable to the pre-effective date period taxed according to the old rules and the remainder according to the new rules. These transition rules would lead to increased computational difficulties.

New Income Measurement Rules

General Proposals. *Blueprints* argues that new income measurement rules are needed to calculate more accurately income from capital or, as it is more commonly termed, business income. Of major importance, in this connection, is the need for allowances for depreciation and depletion to correspond more closely with the real decline in economic value of the depreciable and depletable assets. *Blueprints* also formulates new rules for measuring income in the case of self-constructed assets. All of these rules would significantly affect the simplicity of the proposed tax system.

Depreciation. For calculating capital consumption allowances for machinery and equipment, *Blueprints* advocates a system not dissimilar to the current ADR procedures. The system would involve the following elements: (1) the classification of all assets by types; (2) the mandatory maintenance of a system of vintage accounts; (3) the use of a guideline annual repair allowance for each asset; (4) the application of a specified annual depreciation rate to the undepreciated balance in each vintage account, together with a date on which any remaining balance may be deducted; (5) the computation of annual adjustments of basis in each account by a measure of the change in general price levels during the year.

Similar depreciation rules would be applied to structures, except that

depreciation rates could vary over the life of the structure to reflect the fact that asset values may decline less smoothly. In no case, however, would total depreciation after adjustments for inflation be allowed to exceed the original basis. Gains and losses would be recognized when exchanges or demolitions occurred. Depreciation and repair allowances would always be determined by the age of the structure, not by the time in the hands of the new owner. Expenditures for structural additions and modifications beyond guidelines would be treated as new investment that would increase the asset's depreciable base.

Under the recommended procedures, all rules for estimating guideline depreciation rates and repair allowances would be "subject to continuous revision to reflect new evidence on actual experience and changing technology." [24] In this system, it is imperative that information be kept current and that, at the same time, arbitrary reporting requirements be kept to a minimum. Survey techniques modeled on current procedures of the Office of Industrial Economics of the Treasury Department may be used, but the type of information needed—maintenance outlays and rates of depreciation, in addition to asset lives—would be more extensive.

In addition, a large educational effort would be required, at least initially, to familiarize taxpayers and practitioners with these new rules. The IRS would have the particularly important task of promulgating this information in a form that would be enforceable and understandable, particularly to small businesses. Any rule for depreciation, however, requires monitoring and enforcement; and once understood, the particular rules in *Blueprints* need not be any more onerous than existing depreciation procedures.

These rules would, moreover, have the effect of reducing the differential tax advantages of alternate investments. Since excess depreciation is, perhaps, the most common ingredient in tax shelters, the establishment of a system of depreciation allowances more congruent with economic reality would diminish, if not eliminate, the incentives of taxpayers to seek out these shelters. The tendency toward dynamic complexity, which, as noted earlier, is particularly important in the case of tax shelters, would be greatly abridged.

Also as indicated in connection with capital gains taxation, the adjustment of depreciation allowances for inflation would reduce the need for legislative solutions to offset the effects of inflation on the taxation of income from capital. Moreover, legislative solutions, while often sufficient in the aggregate, albeit with a lag, are seldom the appropriate

[24] BLUEPRINTS, *supra* note 1, at 65.

correction for individual industries. As a result, the tax environment for particular investments in an inflationary world is marked by a high degree of uncertainty.

Depletion. *Blueprints* also restructures the rules governing the taxation of mineral deposits. The problem here is that the economic value of a mineral deposit becomes fully known only after the deposit has been completely exploited, whereas an annual depletion schedule must be estimated from the onset of production from the deposit. Uncertainty about extraction and marketing costs and mineral prices in the future, as well as the extent of the discovery itself, makes the task of valuation particularly difficult.

Economic competition among suppliers of minerals tends to ensure that the costs of seeking mineral deposits, at least in an expected value sense, are equal to the returns from this activity. On this basis, *Blueprints* argues that the best objective measurement of the market value of the mineral deposit prior to production is the total expenditures made for discovery and development of the deposit. *Blueprints* would, therefore, require the capitalization of all preproduction expenditures (other than for depreciable capital, which would be separately depreciated under the rules already discussed). Depletion deductions for tax purposes would then be based on initial production rates combined with guideline decline rates derived from average experience. Over time—*Blueprints* recommends five years—these rates would be adjusted for each property to reflect individual experience. But in no case would total depletion deductions exceed cost (after adjustment for inflation).

Under these rules, tax administrators would be compelled to develop average guideline rates and workable procedures for periodically revising them in the case of particular deposits. Taxpayers would have to learn how to comply with these accounting procedures. On the other hand, investments in mineral deposits would lose their appeal as tax shelter devices, with favorable implications for reducing dynamic complexity. The net result, in this case, would undoubtedly be an increase in complexity; but the extent of the complexity would depend upon the workability of the guideline procedures.

Self-Constructed Assets. Finally, current law accords favored treatment to capital assets constructed by a firm for its own use relative to assets purchased from other firms. For self-constructed assets, income accruing to suppliers of equity during the period of construction is not currently recognized because there is no sale of the completed structure.[25] To

[25] Prior to 1976, certain construction costs, such as preproduction interest and taxes and

equalize the tax treatment of self-constructed and other assets, *Blueprints* would require all costs of constructing an asset for a firm's own use (except interest paid) to be maintained in a separate account. "During the construction period a guideline rate of return would be imputed to the average value of this account and added to the tax base of the builder and also to the depreciable basis of the owner."[26] The assets in service would be depreciated under the rules already discussed. Since the guideline return is imputed to the portion of the structure financed by debt as well as equity, interest costs are already included in the procedure and need not be separately added.

The rationale for this treatment is that capital tied up in these assets must pay a rate of return that is at least equal to what the capital could earn in alternative uses or the investment would not have been undertaken. The imputation of income is therefore necessary to equate the tax treatment of such assets with other assets. This imputed return is added to the depreciable basis of the property to avoid taxing capital.

These rules to reduce the favored tax treatment of self-constructed assets need not involve much additional complexity, since essentially the same rules are already in use for rate-making purposes in the case of utilities, the major industry that constructs its own assets.

Transition Considerations. *Blueprints* recommends that assets already in place when the new income measurement rules take effect continue to enjoy the old tax treatment as long as they remain in the hands of their initial owners. The additional complexity here would be the need to follow two separate sets of accounting rules—one for new and one for old capital assets. The transition period would continue until all existing assets had either been retired or changed hands. A possible modification is to switch to the new rules with respect to the undepreciated or undepleted basis of existing assets at some future date, say in 10 years.

The Taxation of Retirement Income

General Proposals. *Blueprints* also deals with the difficult issue of the taxation of accruing rights to receive future income, such as pension and social security benefits. Consistent with the concept of a comprehensive tax base, *Blueprints* would establish rules that would approximate

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fees paid to local governments, could be deducted as current expenses. The Tax Reform Act restricted the amount of those expenditures that could be expensed somewhat by requiring, for taxpayers other than corporations, that real property construction period interest and tax expenditures be capitalized and amortized over a 10-year period.

[26] Blueprints, *supra* note 1, at 67.

accrual taxation of the value of these pension rights by combining the full taxation of pension benefits when received with the taxation of pension fund earnings. Furthermore, neither employer nor employee contributions would be taxed when made. This method is based on the idea that accrual taxation is generally equivalent to the full taxation of realized benefits plus a deferral charge. The tax on pension fund earnings under the *Blueprints* proposal represents the deferral change.

To see how the system under *Blueprints* would approximate accrual taxation, suppose that a taxpayer has the same marginal tax rate of 20 per cent in his working years and in his retirement years. Let an employer contribute $100 to a pension fund for the last working year to be available to the taxpayer as retirement income next year. Suppose also that the money in the fund can earn 10 per cent.

If a full accrual system were in effect, in year 1 the taxpayer would pay a tax of $20 on the $100 contribution at the beginning of the period, leaving $80 in the fund, and also an additional tax of $1.60, equal to 20 per cent of the $8 of earnings of the fund during the year (10 per cent of $80). At the end of the year, he would have prepaid taxes of $21.60 on his retirement pension of $86.40 ($80 + 8 − 1.60) resulting from the transaction. Since taxes were prepaid on the amount in the fund, he would be allowed to receive a distribution of $86.40 from the pension fund tax-free.

Under the system recommended by *Blueprints*, both employer and employee contributions to pension funds would be tax deductible. In this case, there would be no tax liability for the taxpayer on the $100 employer contribution during his working year. There would, however, be a $2 tax on his $10 of accruing interest income during this year. In addition, the distribution of $108 in the fund to the taxpayer would be fully taxed at a 20 per cent rate ($21.60), leaving him $108 − $21.60 = $86.40 in his retirement year, exactly the same amount as in the accrual taxation case.

Thus in the case of a taxpayer who stays in the same marginal tax bracket and receives fully all the retirement income accumulated on his behalf, an accrual taxation system can be approximated by taxing pension fund earnings as they accrue and by fully taxing benefits.

In contrast, the current taxation of retirement benefits is a mixture of several elements. Employer contributions are generally excluded from income, but not all employee contributions are currently deductible. Also although benefits in excess of tax prepaid contributions are generally fully taxed when received, there is no deferral charge for the postponement of tax. In addition, contributions to retirement plans

by the self-employed (or by employees who have no employer-sponsored plans) and earnings of retirement plans are exempt from tax. Since most pension plans, with the exception of government plans, require no employee contributions, the current system can be characterized as largely on a realization basis, whereas the *Blueprints* system is an attempt at approximating an accrual basis.

In fact, because of problems created by vesting rights and the uncertainty about the length of life, the treatment in *Blueprints* would be fairer in an *ex post* sense than would an accrual system. Persons who lived shorter than normal lives would pay less tax than under a pure accrual system, since *Blueprints* would tax benefits when received, rather than contributions when made. Conversely, for those who lived longer and therefore had more benefits, *Blueprints* would subject relatively more income to taxation. In the case of pensions that had not become fully vested, earnings would be taxed to the employer. If the employer were in a higher marginal tax rate than the employee, as could be the case, the attractiveness of this kind of deferred compensation arrangement would be diminished. There would, however, continue to be a tax advantage to pensions under the *Blueprints* scheme to the extent that a person's tax rate is higher in his working years (when his contribution is deductible) than in his retirement years (when his benefit is taxable). The advantage of this treatment would be less under a comprehensive income tax system than under current law because of the smaller differences in marginal tax rates and the wider tax brackets.

The overall impact of the reforms outlined in *Blueprints* would be to diminish the economic attractiveness and the use of pension plans as vehicles for providing retirement income. With the possible exception of the gain in simplicity from a decreased use of pension plans, little would be achieved in reducing complexity relative to current law for those pension plans that remain in existence. For individual taxpayers who would receive notices of pension fund earnings along with their annual W-2 statements, no additional complexity is involved. But pension funds would have the additional requirement of calculating and reporting to employees (and employers for not fully vested plans) their share of the taxable earnings of pension funds. This would be in addition to all other reporting and financial responsibilities under which pension plans would continue to operate. On the other hand, since all benefits would be taxed, no computation would be needed to determine which portion of pension benefits are a return of tax-paid contributions and which are taxable income. Inasmuch as the current rules are quite complex, this could represent a substantial simplification.

Some 44 million tax returns, or about 52 per cent of those receiving wages and salaries, would include pension-fund earnings in income. As noted, this information would be made available on W-2 forms received from their employers. Another 11 million returns would also have pension benefits subject to tax, as under current law.

In addition to private pensions, a major source of retirement income for many people today is social security. For example, in 1976 the social security system paid out over $6 of retirement income for each dollar paid out by private pension plans.[27] Under current law, social security benefits are not taxable, but only employer contributions are excluded from income. It is possible to view social security as a pension plan under which the benefits actually received result in some *ex post* rate-of-return on employee and employer contributions. It is virtually impossible, however, to calculate such a return annually. This is because future benefits depend upon the changing conditions of a worker's marital status, number of dependents, earnings record, and the spouse's earnings record.

Consequently, *Blueprints* does not attempt to tax the implicit rate of return on employee and employer contributions to social insurance funds and thus does not implement the same accrual principle for social security as for private pensions. As in the case of pension funds, however, contributions to the fund, by employer and employee, would be deductible and benefits would be fully taxable.

About 72 million tax returns would be affected by the deductibility of employee social security contributions from taxable income, although, as in the case of pensions, their receipt of this information would be handled through the usual W-2 forms. Another 23 million returns would be required to report social security benefits. Over 10 million of these returns receive comprehensive income of $5,000 or less, and a large proportion of these, as a result, would not be expected to be taxable.

The treatment of social security benefits would thus be somewhat more lenient, as well as much simpler, than pension income. Compared to current law, however, social security would be more heavily taxed. The full taxation of benefits would outweigh the deductibility of employee contributions, which are not allowed under current law. Nonetheless, under *Blueprints* the harsher tax treatment of pensions than social security could lead to pressures for increasing the size of the social security program relative to private pensions. Although in a

[27] Department of Health, Education, and Welfare, Social Security Bulletin 17, Table 9 (1977).

sense this kind of development could be regarded as advancing the cause of overall simplicity, equity may not necessarily be improved because the implicit returns earned on social security contributions would not be taxed.

Transition Considerations. Complexity is also likely to be created in moving to the new system of taxing retirement income. For reasons of equity, it would be undesirable to immediately tax all retirement benefits in full. Indeed, any benefits paid out of past accruals have a claim for being treated under the current rules. In response to this, *Blueprints* would allow people currently retired to be taxed under the old rules and people with current retirement accounts to be taxed partially under the old rules. Obviously, developing regulations and forms and monitoring compliance during the transition period could impose burdensome chores on taxpayers and administrators. Moreover, the transition period in this case would last a full generation.

Summary

For most proposals presented in *Blueprints*, the burden of recordkeeping, as in the case of wages currently, would be assumed by the disbursing organization. Information on the W-2 form provided by the employer would include not only wages but various adjustments for pension plans, social security, and employer fringe benefits as well. Thus to the extent that simplification is of more concern to individuals than to institutions, *Blueprints* would not pose serious difficulties.

Because a comprehensive income tax limits exclusions, however, more taxpayers would have to file tax returns. Filing would be an added burden for the currently nonfiling population. The taxpayer assistance industry could count on new business and the Internal Revenue Service would have a larger workload to process.

The elimination of the standard deduction is certain to have an adverse effect on tax simplicity for the low- to average-income taxpayer. Elimination of the standard deduction would increase the number of itemizers, as *Blueprints* would continue to allow deductions for five categories of deductions. This would necessitate additional recordkeeping and calculations on the part of taxpayers who now take the standard deduction, as well as those who do not have to file. Also IRS would have to scrutinize the expenditures of the new itemizers. Since many deductions of current law would be disallowed by *Blueprints*,

however, currently itemizing taxpayers would no longer have to keep records of expenditures that had lost their tax-deductible status.

Proposals in *Blueprints* that would complicate an individual's calculation of tax liability are the basis adjustments for returns with capital gains and with corporate source income. On the other hand, *Blueprints* would simplify the decision-making process for investors, since most of the tensions responsible for dynamic complexity would be eliminated. By equalizing the tax treatment of different investments, *Blueprints* would decrease the necessity for investors to research the tax laws or to have this done for them. Thus although tax practitioners may spend more time assisting taxpayers with calculations of tax liabilities, they would spend less time counseling them on tax planning.

Blueprints would impose additional reporting requirements on income-dispensing institutions. For example, corporate management would have to report to shareholders the share of corporate income and adjustments for changes in basis. Pension funds, in addition to the normal reporting requirements, would have to report the share of pension fund earnings accruing to individuals or to employers, if the benefits had not been vested.

Business accounting staffs would have to learn the new accounting rules for measuring capital income; but once these new rules would be understood, they would not seem to pose any difficulties beyond those of current law. Finally, and perhaps most importantly, the lower structure of tax rates would reduce pressures on legislators to enact the special tax treatments that give rise to dynamic complexity in the first place.

D

Simplification and Other Tax Objectives

Gerard M. Brannon

This is a paper on how to think about tax simplification. That is no simple project because a tax system has multiple, conflicting objectives. An equitable tax system, for example, is one in which the tax is adjusted to all facts relevant to the ability to pay of each taxpayer. A simple tax system is one in which few facts about the particular taxpayer are required to determine tax.

The usual conference or committee says nice things about each objective and blandly asserts that, if we try hard and compromise wisely, then nearly all good things can be achieved. Trade-offs in which some not-quite-good-enough thing is sacrificed are considered dirty business, too dirty to be talked about in a family newspaper.

Simplification does not always lose out. Strong arguments have been made that for simplification we should put up with a host of problems that could be avoided by taxing capital gains on an accrual basis. The problems include determination of tax, formal rate reduction to reduce lock-in, and unequal treatment of capital losses. Similarly, the threat of complications is a powerful argument against attribution of total corporate income to shareholders. In each of these cases, there is remarkably little literature on what the precise cost of these complications is and whether there are effective ways to circumvent them. It may be that simplification is being used as a popular front argument for quite different reasons for opposing these changes, such as that they would make the tax more progressive. It is to be hoped that in this conference we can talk frankly about what we are and are not willing to pay for simplification.

* Gerard M. Brannon is a Professor of Economics at Georgetown University, Washington, D.C.

TAX OBJECTIVES—AN OVERVIEW

To begin, simplification, as such, does not appear directly in my big three tax policy objectives: equity, efficiency, and political acceptability. Simplification and its opposite, complexity, can best be thought about as being an element of these basic objectives, especially efficiency and political acceptability.

By way of ordering the big three, we point out that tax provisions are enacted not because tax experts approve but because a majority of some legislative committee believes it wise, in a political setting, to vote for the provision. The relationship of politics to the technical excellence of tax provisions can be clarified.

A tax provision can be thought of as favorably affecting some citizens if:

(1) It reduces their taxes at an acceptable cost in terms of how much they must change their behavior in order to qualify for the tax relief; or

(2) It increases the taxes of other people, especially people who are competitors; or

(3) It increases the income of these citizens by inducing other people to do more business with these citizens.

This last kind of favorable effect may be direct or indirect. Builders are favorably affected by tax benefits that induce families to buy more housing. Some citizens at large may see themselves benefited by an investment tax credit that will increase economic growth.

Similarly, a tax provision has unfavorable effects on some citizens if:

(1) It increases their tax; or

(2) It reduces taxes of other people, especially competitors; or

(3) It decreases the income of these citizens.

People who on balance think that they are favorably affected by a tax provision will, we assume, regard it as fair or efficient or both. This should, but need not, lead to supporting (voting for, working for, contributing to) politicians who vote for the provision.

How favorable effects are translated into political support depends on the intensity of the favorable effects and on their visibility. Obviously, big benefits are better than little benefits. The subtler point is visibility. A citizen will only respond politically to a vote on a tax question if the citizen thinks that the question makes a difference, but this is only a necessary condition, not a sufficient one. The citizen must be

aware of the politician's position and must regard the politician's position on this tax question as important or what political scientists call "salient."

Similarly, a group unfavorably affected will ordinarily regard the tax provision as unfair or inefficient or both, and the political thrust of these views will depend on the intensity of the unfavorable factors and their visibility.

This political framework for thinking about tax questions does not rule out the relevance of traditional arguments about the equity or efficiency of particular tax rules, based on legal or economic reasoning. Such reasoning, or popularizations of it, may have much effect on citizen perception of taxes. Citizens who will not claim an investment credit may nevertheless think of themselves as favorably affected as a result of the economic growth induced by the credit. It is on this background of citizen perception that we propose to comment on simplification.

In the next section, we explore some fairly traditional sorts of analysis on the trade-offs between simplification, equity, and efficiency. In the discussion beginning on page 200, we extend the analysis to the relationship of simplification to the more elusive goal of political acceptability, which involves the visibility of provisions and citizen perceptions of effects.

SIMPLIFICATION, EQUITY, AND EFFICIENCY—A TRADITIONAL ANALYSIS

In this section, we discuss simplification trade-offs for equity and efficiency, as citizens ought to see the matter, without giving much attention to the specific problems of citizen perception, which will be dealt with in the discussion beginning on page 200.

We start by expressing equity and efficiency in a common metric so as to make some sense of the concept of trade-offs. In principle, equity and efficiency objectives can be reconciled by comparing:

(1) The gain (or loss) in social welfare from imposing a tax burden on X rather than on Y, with

(2) The loss (or gain) in social welfare from any resource reallocation that arises from imposing a tax burden on X, rather than on Y.

An investment credit is unfair, but it is good tax policy if the increased investment that it generates produces more social benefit than the social harm produced by shifting to ordinary taxpayers some of the

burden that would otherwise be carried by the patently prosperous group, investors.[1]

My basic assertion about simplification is that the complication involved in a tax provision is one of the resource misallocations of the provision. In this way, complication (or simplification) can be brought into the equity/efficiency trade-off. We illustrate this with the investment credit.

Assume that the income redistribution associated with enacting an investment credit in lieu of general rate reduction is equivalent to a reduction in the welfare value of income of 12 per cent. This is to say that an investment credit increases the after-tax income of investors by $5 billion, whereas by rate reduction we could have increased by $5 billion the after-tax income of all taxpayers, a poorer group than all investors. My 12 per cent figure asserts that, due to diminishing marginal utility of income, social welfare is increased as much by adding $0.88 to the income of all taxpayers as it would be by adding $1.00 to the income of all investors.[2]

Assume further that with the investment tax credit, investors use their $5 billion in a way that produces 35 per cent more benefit to society than would be provided by the mix of consumption and saving that would have been chosen by all taxpayers if their taxes had been reduced by $5 billion. From these figures, it follows that we are better off with the investment credit than with the rate reduction because 88 per cent of 135 per cent (or 119 per cent) is greater than 100 per cent of 100 per cent.[3]

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[1] In a broader context, one may argue that the investment credit is not unfair because the tax system should not have taxed savings in the first place, the system should not have been progressive, and so forth. These questions are beyond the present paper, which is about simplification within the kind of tax that we have in the United States.

[2] To evaluate the equity aspect of this shift, we calculated the average AGI on all tax returns in 1974, weighted by the average tax rate ($16,253). We then calculated another average AGI in which returns in each size bracket were weighted by rc, where r is the ratio of the nonwage and salary component of AGI in the bracket, and c is the value of the credit. Since the credit does not reduce basis, c was set at the credit rate plus (1 + .60m), where .60 is our estimate of the current value of depreciation and m is the median marginal tax rate in the bracket. This produces an average income of $17,670. It is a common assumption in the optional tax literature that the marginal utility of income is a declining linear function of the log of income. *Cf. e.g.*, Fair, *The Optimal Distribution of Income*, 85 Q.J. of Econ. 551 (1971). Combining this assumption with the cited averages, we calculated that the distributional effect of the investment credit reduces the utility of income by 12 per cent of the amount shifted.

[3] We assume that the marginal return on business investment is 12 per cent and that the social rate of time preference is 7 per cent. (Feldstein, *Does the U.S. Save Too Little?*, 67 Proc. Am. Econ. A. 116 (1977). It follows that if the induced investment cost more than it did by 70 per cent, it would be of strictly marginal value as a contribution to welfare, and thus this 70 per cent is the measure of its net contribution. We further assume that $1 of investment credit induces 50 cents of net additional investment. This

To extend the analysis to complication/simplification issues, assume still further that having an investment credit in the law requires a certain amount of administrative resources for tax compliance, tax planning, and tax auditing, and that these complication costs amount to 10 per cent of the revenue loss.[4] Since resources devoted to dealing with tax law complications are a dead weight loss to society, this should be subtracted from the efficiency gains.[5] Now our discriminant function becomes (88 per cent of 135 per cent) less 1 per cent or 115 per cent, which is less than the value of tax rate reduction. Under these assumptions, we would conclude that the investment credit is a good provision. It produces enough *net* benefit to justify the modest complication it entails.[6]

Before extending this analysis of tax simplification, we should note that this is precisely the way we would handle administrative costs in the benefit/cost analysis of an expenditure program. A preliminary analysis might suggest a gain in social welfare (benefits greater than cost) from imposing tax on incomes above the poverty level and distributing food stamps to the poor. Before adopting this conclusion, we would add in the administrative costs of handling a food stamp program, which could tip the balance so as to make costs exceed benefits. Analogizing tax complication costs to administrative costs of expenditure programs, commonly called red tape, suggests that there might be as much nonsense repeated about tax simplification as there is about "cutting red tape." I am impressed with the definition that red tape is the part of somebody else's business that I don't understand.[7]

If it is agreed that complication costs can, in principle, be combined with equity and efficiency effects of tax provisions, it only remains to be

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judgment is based on a variety of published estimates of the elasticity of substitution of capital for labor and of the elasticity of the rate of savings with respect to the after tax rate of return. *Cf.* Brannon, *The Effects of Tax Incentives for Business Investment: A Survey of the Evidence*, in 3 THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS (1972).

[4] The administrative cost of the Internal Revenue Service is about 0.5 per cent of revenue, and if we guess that the taxpayers' costs are three times the IRS' cost, we get an overall cost of compliance of 2 per cent. The investment credit is certainly one of the relatively simple provisions of the tax code. Our guess is that the complexity cost is well below 2 per cent.

[5] For a similar addition of complication costs with efficiency gains and losses, *cf.* R. Musgrave & P. Musgrave, PUBLIC FINANCE IN THEORY AND PRACTICE 476 (1973).

[6] This formalization of equity and efficiency effects will appear to some as very austere theory and therefore impractical. One comment is that this must be the kind of analysis that tax writers go through mentally, even when they are intuiting that the investment credit is good or bad. A further comment is that an extremely promising line of economic analysis of taxes, the theory of optimal taxation, has developed in a fashion similar to what we have done here. *Cf. e.g.*, Atkinson, *How Progressive Should Income Tax Be?* in ESSAYS ON MODERN ECONOMICS (M. Parkin ed. 1973).

[7] An enlightening discussion of administrative costs of expenditure plans is provided in H. KAUFMAN, RED TAPE: ITS ORIGINS, USES AND ABUSES (1977).

pointed out that this analysis can be applied at the margin to ask "How much of the equity/efficiency gain from a provision is lost if we change it to reduce the complication cost?" This is the pure tax simplification issue.

As a rule, we would expect this pure simplification question to be difficult to answer because simplification will often involve giving up some of the benefits of the provision. Serious analysis requires specifying both the benefits of the provision and the reduction in complication costs.

To illustrate such an analysis, we consider the simplification of imposing a 2 per cent floor on contribution deductions, that is, for a taxpayer who itemizes, an amount of contributions deductions equal to 2 per cent of adjusted gross income (AGI) would be disallowed. First we describe some formalities, based on data for 1972. In that year, 12.8 million returns itemized charitable contributions below 2 per cent of AGI. We estimate that all of these would stop itemizing and that half the people whose contributions were between 2 and 3 per cent of AGI would stop itemizing, another 2.3 million returns. The contributions accounted for on these returns comes to $3.2 billion, and the tax saving from this deduction comes to $912 million.

This tax law change would reduce the effect of contributions deductibility, encouraging gifts to charity, while it would simplify the system by reducing the amount of itemization on tax returns.

First, in regard to efficiency, we calculate that for 1972 this change would have reduced the revenue "loss" due to contributions deductibility by $912 million. We ignore fairness issues because we assume that the revenue gain is returned to the same brackets by rate reduction. We measure the efficiency of the contributions deduction by the increase in contributions to charity that has been induced by deductibility.[8]

In recent years, there has been considerable research on the price elasticity of contributions, that is, the prospective change in contributions due to a change in the after-tax price of contributing $1. We suggest below a range of estimates for this elasticity. For each estimate, we give the implicit estimate of the contributions induced by present

[8] One could argue that there is an element of fairness or unfairness in a rule that taxes each person's income net of contributions, whether or not contributions are stimulated thereby. The issue is discussed extensively in Andrews, *Personal Deductions in an Ideal Income Tax*, 86 Harv. L. Rev. 309 (1972), and in Department of the Treasury, Blueprints for Tax Reform (1976). To the extent that one wants to pursue this issue, assessing a simplification proposal is even harder than is suggested in the text.

law deductibility of the contributions that would be cut out by the proposed simplification.[9]

Price Elasticity of Contributions	Reduction in Contributions Due to a 2 Per Cent Floor
1.0	$ 910 million.
1.25	1,130
1.5	1,350
2.0	1,820

We must make some estimate of how much social welfare is increased by inducing some transfer of resources from taxpayers to beneficiaries of charity. I know of no such estimate, but clearly disinterested advocates of charitable contributions deduction have asserted that social welfare is increased by these transfers. It would be consistent with such a position that at the margin the net gain in social welfare from a little larger transfer is zero. (If this were not the case, one should advocate making contribution deductions more attractive.) Clearly, the 2 per cent floor proposal would make only a marginal difference in charitable contributions.

In the hope of inducing others to make a better estimate, I suggest that we consider several estimates of the social welfare benefit of having money spent for charitable purposes, rather than for noncharitable purposes: The proposed social welfare estimates involve net gains of 1 per cent, 3 per cent, and 5 per cent. This yields a matrix of benefit estimates from allowing deduction of the $3.2 billion that would be disallowed by a 2 per cent floor.

Value of Increase in Social Welfare

If the welfare ratio is	and if the elasticity is			
	1.0	1.25	1.5	2.0
	$ million			
1 per cent	9	11	14	18
3 per cent	27	33	42	54
5 per cent	45	56	67	91

The remainder of the simplification issue is to estimate the value of administrative and compliance resources saved as a result of the

[9] Sources: The ranges of price elasticity are suggested by the essays by Feldstein and Clotfelter, in 3 Commission on Private Philanthropy and Public Needs, Research Papers (1975). An evaluation of these estimates is provided by Arnold Zellner in the same volume.

floor proposal. If half the 15 million return filers who lose a contributions deduction under this proposal would forget about contributions deductions, we estimate that the saving per tax return would be a reduction of ½ hour of work in collecting records and tabulating contributions. Valuing time at $7.50 per hour, this amounts to a resource cost of $28 million.[10]

In addition, we estimate the other 7½ million will continue record-keeping and some tabulating, aborting the project when they discover that they do not make the 2 per cent floor. We put this saving at only ¼ hour or $14 million. Finally, we assume that 5 per cent of itemized deduction returns are audited, which is 750,000 returns affected by the floor. We assume that not having to verify a contributions deduction saves ¼ hour of the time of each two people, a total of $3 million.

In the negative direction, we have 11 million itemizers still recording contributions but going through the extra fuss of reading about the floor rule and making the necesary calculations. At four minutes a return, this imposes a cost of $4 million.

Summarizing, we have resource savings of $(28 + 14 + 3 − 4) = $41 million.

We do not know what "the answer" is on a 2 per cent contributions floor. If we guess that the price elasticity is around 1.5, we would have to conclude that the simplification is inefficient, unless we are willing to assert that there is only a 3 cent or less gain in social welfare from transferring one dollar from use by taxpayers to use by charities. This seems to me to be a very low estimate of the value of charities, even at the margin.

If it is so hard to analyze a simple simplification like this, a question arises: What can a talk session like this possibly accomplish except to spout shallow generalities? It should be the case that each feature of the tax law serves some purpose, and simplification should throw us into well-nigh impossible trade-off issues.

It is the hope of tax simplifiers that a diligent search will produce many situations in which some simpler form of the law can be shown to be at least as efficient as the more complex form. This delightful outcome makes it unnecessary for the simplifier to get into the dirty business of trade-offs. In baseball language, the simplifier

[10] In 1972 24 million returns with itemized deductions also reported salaries and wages of $350 billion, about $15,000 per return. On some returns two earners were included, which makes our average too high, and on some returns only part-time work is covered by salaries and wages, which makes our average too low. Fifteen thousand dollars spread over 50 weeks of 40 hours is $7.50 hour.

is looking for a cripple pitch that can be easily hit out of the park. If there were simplification steps as obvious to take as this, they should have been done already.

Oddly enough, there are some cripple pitches around for us to hit. Quite plausibly, there are some easy simplifications that have not been thought of before, or at least not discussed publicly.

To encourage my colleagues, I offer a new one. Repeal the deduction for state and local sales taxes; calculate how much revenue would be gained; and mail out checks in this amount annually to states and localities that have sales taxes. The sole effect of deductibility must be to make adoption of sales taxes and rate increases in sales taxes easier for state and local governments because an increase of $100 in tax will be softened by $8 of federal tax saving.[11] Exactly the same encouragement to higher state and local taxes could be provided far more efficiently by letting the United States Treasury mail the $8 directly to the states.

Over and above the new ideas that we could concoct, I think there are other cases where one could suggest simplifications that would reduce administrative cost and, at the same time, be at least as efficient as the more complex forms. These are cases where the Congress knows that the simpler form is more efficient, but refuses to enact the simplification. I will cite one such case and use it to demonstrate that there is more to the simplification issue than a trade-off between fairness and efficiency. This will provide a bridge to our discussion of simplification and politics, beginning on page 200.

Emil Sunley has demonstrated that modification of the investment credit by making the credit refundable, requiring basis adjustment, eliminating the short life rule, and eliminating recapture would simultaneously increase the effectiveness of a given revenue loss via the credit and greatly simplify it.[12]

The technical point about increased efficiency can be seen easily. Assume a 10 per cent investment credit with complicated limitations so that it applies to only half of investment. This should induce new investment for eligible situations in which the prospective profit is anywhere from barely equal to the cut-off rate to 10 per cent below. Compare this with an equal revenue loss 5 per cent credit applicable to all new investment. The latter will induce new investments with

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[11] In 1972 states and localities raised $21.5 billion in general sales taxes, of which $6.2 were deducted at a revenue cost of $1.74 billion (U.S. CENSUS GOVERNMENTAL FINANCES, IRS STATISTICS OF INCOME).

[12] Sunley, *Towards a More Neutral Investment Tax Credit,* 26 NAT'L TAX J. 209 (1973).

prospective returns between the cut-off rate and 5 per cent below. Clearly, the 5 per cent credit is simpler; it does not have the complicated limitations. The two should induce the same amount of new investment; one provides half the inducement per case, but it applies to twice as many cases. The broad-based simple credit is more efficient because it induces investments that are more profitable, within 5 per cent of the cut-off rate, rather than within 10 per cent, and the market test for efficiency is profitability.

One must infer that the political process eschews this kind of simplification, since rationalization of the investment credit has been proposed, but has not made it to first base with the Congress. Many taxpayers benefit from the present complications because more of the credit goes to them. Counsel for these taxpayers make a case for retaining the preferential treatment, a case that Congress apparently cannot refuse.

More is involved in simplification than efficiency, as dreamed of in an economist's philosophy.

SIMPLIFICATION AND POLITICS

We suggested earlier that tax provisions are adopted because enough legislators think that it is wise politically to vote for them. Political acceptability, in this sense, will be somewhat related to a technical analysis of equity and efficiency, including complication cost, along the lines we discussed in the previous section. For one thing, legislators will get some advice from disinterested "experts" and, if the noise from partisans is not very loud, expert advice may carry some weight. Political acceptability, however, covers more than a technical analysis of equity and efficiency.

For one thing, legislators will mostly hear evaluations of equity and efficiency from groups very favorably and unfavorably affected by a provision, and we have posited that people favorably affected will consider the provision fair or efficient or both and *vice versa*. Even a cursory examination of tax hearing records establishes the overwhelming dominance of partisans. Further, what legislators hear will be conditioned by the visibility or political salience of the tax provision at hand.

We do not intend a complete political analysis of how tax provisions get adopted. We merely offer some observations about the relevance of simplification and complexity to this political process. From this

viewpoint, a striking observation emerges. Many complications are in the law not because they represent a careful balance of efficiency and equity, but because they have quite different kinds of effects. Two of these effects are "the picket fence effect" and "the mystique value effect."

In many cases, a set of complications in the tax law appear as limitations around a preferential provision. Simplification could be achieved by relaxing the limitations and letting the preference apply to a larger number of cases and by reducing the value of the preference for cases to which it does apply. The illustration of the investment credit, mentioned in the previous section, is a simplification of precisely this type.

Naively, one might expect that these simplification proposals would be politically viable. There are some who lose, but there are also some who gain. The obvious reason that these simplification proposals do not survive is that the issue has far greater visibility to the group already inside the picket fence of limitations, restrictions, eligibility conditions, and so forth. These people would be losing something that they have now. The other group would be getting something that they do not have now. Losers will make more noise than gainers.

The picket fence effect is reinforced by the politics of trade associations. Consider an obvious simplification of the mining provisions, namely, to eliminate the 50 per cent of net income limitation and simultaneously to reduce the per cent-of-gross rates of percentage depletion to eliminate any revenue loss. For a mining association, this would help some members and hurt others. In this case, I would think that it would be virtually impossible for an association to testify for a provision that hurts some of its members. The association must find some safe straddle, such as recommending that the percentage-of-gross rates be increased at the same time that the 50 per cent of net limitation is removed. This converts simplification into relief for the entire mining industry and, with the attendant revenue loss, the recommendation will fail. This is of no great consequence to a trade association. What a trade association should maximize is its own survival, which in our sequence is protected.

A striking historical example of the picket fence effect relates to various proposals to simplify the tax benefits for the aged. Invariably, this is connected with reducing benefits to the rich aged and removing some complex limitations on benefits to low-income aged. Even though far more low-income aged would benefit, the rich aged win. They protect their picket fence.

Apart from this picket fence effect, complex limitations have a

mystique value. Here again, the natural resource rules provide an example, in fact, several examples, so we begin by saying more about the complications. The value of percentage depletion is apparently fine-tuned by many remarkably complicated rules to distinguish mining and manufacturing (cut-off points, treatment processes, and so forth), as well as rules to implement the 50 per cent of net limitation (rules about lease bonuses, ABC transactions, and so forth).

At a serious level, it is demonstrable that both of these sets of rules reduce the efficiency of the mineral incentives that were presumably intended by the whole mess. The 50 per cent limitation does this by concentrating benefits in the most profitable properties, the ones that would have been developed anyway. Simultaneously, it denies benefits to marginal properties, the ones that one would expect to be encouraged in a program to expand mineral production.[13] The mining/manufacturing distinction is likewise counterproductive. If a firm develops a process of making an end product from cheaper raw material and more manufacturing, we should applaud the conservation; but the complicated tax rules punish this conservationist.[14]

Although these depletion complications are economic nonsense, I suggest that they serve to reinforce this mystique: that firms that squeeze past an obstacle course of complicated qualifications must be worthy. The mystique is carried by the notion that mining is different (hence the cut-off point nonsense) and by the notion that efficiency is profitability (hence the net-income limitation, despite the crucial importance of marginal operations to increase mineral output).

The percentage-of-tax limitation on the investment credit also has some mystique value: that investment by profitable firms must be efficient. But an investment credit works by making some submarginal investments into supra-marginal investments on an after credit basis. Economically, the submarginal investments of profitable firms are not better than the submarginal investments of nonprofitable firms.

The most striking illustration of the mystique value of complications is provided by some recent provisions dealing with limitations on so-called tax abuses, the minimum tax and the limitation on accounting losses.

Basically, a minimum tax provision is a limitation on certain tax preferences that serves to penalize persons whose investment is con-

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[13] This inefficiency argument is elaborated in Miller, *Percentage Depletion and the Level of Domestic Mineral Production*, 15 Nat. Resources J. 241 (1975).

[14] This inefficiency argument is elaborated in Brannon, *Existing Tax Differentials and Subsidies Relating to Energy*, in Studies in Energy Tax Policy (Brannon ed. 1975).

centrated in a tax-favored area. From a minimum tax standpoint, a dirty bird is a taxpayer whose investment and personal commitment is entirely in oil well drilling or in promoting shopping centers. (Exclusive investment in a tax-favored area could produce a zero tax rate and thus a minimum tax.) From a minimum tax standpoint, a good bird is a taxpayer who has mostly taxable income from a profession and who dabbles in oil on the side. A sideline investment is consistent with some significant overall tax; thus it will not run into a minimum tax penalty.[15]

Now contrast the thrust of various provisions imposing a limitation on accounting losses. These provisions are structured to prevent losses in excess of income on a tax-favored project from being used to reduce income on another activity. From this standpoint, the dirty bird is the professional who dabbles in tax loopholes; and the good bird is the loophole specialist. It is just the opposite configuration as that of the minimum tax.

I assert that these complications of minimum tax and limitation on accounting losses provide no increase in efficiency for the complications they generate. They simply disqualify certain taxpayers from some benefits. This could have been done far more simply by reducing the benefit itself or by selecting qualified applicants from a table of random numbers. The complicated rules in the tax code, however, serve a different purpose than efficiency. They contribute to a mystique that the tax preference is worthy because we have identified some who were "abusing" the provision and have thrown them out. It makes no difference which set of users we decide to call abusers; all that is required is that the image be created that the rest of the crowd is worthy. This reduces opposition from the bulk of voters by leading them to think that the preference serves to increase the GNP and thus increases incomes of people at large.

CONCLUSION

This paper was intended to state issues, rather than offer conclusions, but a few concluding comments are appropriate.

The formal analysis of tax policy is, I think, still at a very rudimentary stage. Tax debates abound in generalities, and we are barely able to say whether various provisions should or should not be in the law. Serious analysis of the efficiency/equity aspects of detailed complica-

15 The 1976 Act partly converted the minimum tax into a flat tax on preferences, but still it imposes no penalty on the dabbler.

tions is a long way off. Still, some modest simplifications may be urged on the grounds that they are at least as efficient and simpler.

Even in these areas, the relevant tax policy debate is carried on in an adversary fashion by groups that are hurt or helped by the provision. In this debate, complications serve purposes other than efficiency; and we should expect that continued adversary debate will produce more complications.

It does seem to me that the structure of our tax debates is such that legislators are hard put to utilize even those arguments that we now offer about efficient simplification. Another good law review article does not have much prestige value in convincing voters that a simplifying provision would help them. The kind of institution that might reinforce such conclusions would be a prestigious commission. If we had such a group, made up of other than a collection of representatives from each powerful group interest, it is plausible that legislators could use the findings of the "Simplification Commission" to convince broad groups in the electorate that they have something to gain by simplification. The real meat of my political analysis is that complications frequently help some and hurt others, and they stay in the law because the Congress only hears from the groups who are helped. Creating institutions that could communicate with the silent majority might change the outlook.

E

Simplification of Individual Returns

Personal Deductions—Charitable Contributions

Harry K. Mansfield

SIMPLIFICATION OBJECTIVES

A discussion of possible steps for simplification of the personal deductions provided in the individual income tax necessarily raises the question: For whose benefit will that simplification be designed? It is apparent to me that the principal beneficiaries ought to be the individual taxpayers. There are, however, other persons whose needs should be considered, such as tax return preparers, tax planners or advisors, tax administrators, and judges. Nevertheless, it is reasonable to conclude that substantial simplification for taxpayers will also result in simplification for others concerned.

A taxpayer undoubtedly approaches the question of tax simplification or complexity from the point of view of the preparation of his own income tax return. Recent statistics disclose that about 50 per cent of individual income tax returns have been prepared by professional preparers, an indication that as many as half of the individual filers believe they need assistance in coping with the preparation of their returns. Consequently, a principal focus of simplification efforts should be directed at the return itself, although the likelihood exists that almost any simplification proposal would simplify return preparation. This could mean consideration of proposals for complete elimination of particular itemized deductions or for elimination or revision of particular credits or for simplification of the statutory restrictions and limitations required to be applied in deriving the numbers to be in-

* Harry K. Mansfield is a member of Ropes & Gray, Boston, Massachusetts.

serted in the return. For example, the general tax credit, which was a somewhat involved separate computation on the 1976 return, has now been built directly into the tax tables for those not required to use Schedule TC. On the other hand, the complete elimination of an available deduction, such as the deduction for gasoline taxes, would dispense entirely with the need for assembling the information for making the computation and also for inserting the result on the return.

It is probably equally important to ensure that any simplification proposal will not only simplify return preparation but will also minimize recordkeeping by taxpayers. The elimination of the deduction for gasoline taxes would, of course, accomplish that result completely, although many, if not most, taxpayers compute the deductions by estimation, rather than by recordkeeping. Since large numbers of individuals apparently find it difficult to compile and to preserve adequate financial records, it seems obvious that reduction of recordkeeping is an important objective, which, in turn, leads to simplification of return preparation. It would have consequential benefits for the tax return preparer and especially the tax administrator, who would be spared the necessity of verifying those financial records.

EFFECT OF STANDARD DEDUCTION

The principal technique for the elimination of recordkeeping and the simplification of return preparation has been the standard deduction. This deduction, when first introduced in 1944, was employed by about 70 per cent of individual taxpayers, but that proportion has diminished to about 40 per cent as itemized deductions have become more extensive and useful with the impact of inflation. The standard deduction was increased under the 1976 Reform Act, and it is estimated that about 75 per cent of individual taxpayers used it for 1976 returns. It permits the use of the short form return, Form 1040A, and reduces almost to the vanishing point the necessity for recordkeeping, certainly for deductible items. Surprisingly, many taxpayers employing the standard deduction nevertheless also employ professional preparers. The various changes under consideration by the Carter administration do not involve a change in the standard deduction itself. Other contemplated changes, however, are estimated to result in future utilization of the standard deduction by about 83 per cent of the individual taxpayers, thus leaving less than 20 per cent of individual taxpayers who will file returns with use of itemized deductions.

If the number of itemizers falls to such a low proportion, it is obvious

that the separate itemized deductions will be significant to only a relatively small class of people paying high rates of tax. Under these circumstances, the nature and extent of each available deduction should be reexamined closely in order to demonstrate clearly the financial and social reasons for allowance of the personal deductions. It is a manifest consequence that simplification will be achieved for only a limited class of taxpayers by elimination of further deductions, and it would appear that any eliminations would also further stimulate use of the standard deduction. A flat standard deduction of $3,200 for joint returns and $2,200 for single returns (replacing the minimum, percentage, and maximum standard deductions) has now been built into the tax tables, which, for non-itemizers, are applied directly to adjusted gross income (AGI). Itemizers must subtract the standard deduction (now called the "zero bracket amount") from the total of their itemized deductions and then subtract the difference from their AGI before applying the tax tables. But the tax tables cannot be used by single individuals having taxable income over $20,000 or by joint taxpayers having taxable income over $40,000. It is expected, however, that 96 per cent of taxpayers will use the tax tables, rather than the tax rates fixed by statute.

Personal deductions, therefore, should remain available for this limited group of itemizers only in order to arrive at a more satisfactory composition of taxable income or to provide a substantial tax incentive for certain expenditures.

USE OF CREDITS

The substitution of a system of credits for deductions, as sometimes suggested for reasons of tax equity, will not simplify the tax system. If credits are not refundable, stacking or ordering rules must be provided to determine their priority of application. They also require several steps for their computation, as demonstrated by the current tax return. The presently available tax credits can be divided into two categories:

(a) Business-related credits (investment credit, WIN credit, jobs credit)

(b) Individual nontrade or business credits (child care expenses, foreign tax, earned income credit, and political contributions credit).

The general equitable argument for credits is that they are worth the same dollar amount to each taxpayer, without regard to his marginal tax bracket; thus they treat all taxpayers equally. Of course, this is not really true for vanishing credits (for example, earned income

credit) in the case of high-income taxpayers or nonrefundable credits for nontaxpayers. Against this, one must consider the argument that the use of a tax credit impairs the income-defining function of deductions, for if the income tax is to be based on ability to pay, certain deductions will be and are properly worth more to high-income taxpayers than to low-income taxpayers. The use of credits muddies this process.

Essentially, a credit is a fixed amount governmental subsidy for the particular expenditure or is a form of government coinsurance. A deduction, on the other hand, is a means of determining the proper measure of taxable income, or it serves as an incentive to high-bracket taxpayers. Unless all personal or nonbusiness deductions are to be eliminated, the determination of whether a credit or deduction is appropriate for a particular item of expenditure should be analyzed in terms of the nature of that item in the context of determining taxable income. Thus a separate analysis should be made for each item. For example, the shift from a deduction to a credit for child care expenses, implying, as it does, a federal subsidy scheme for child care, seems wrong if these expenses are primarily considered expenses of earning income. Although there will be some disagreement about the basic nature of each item, a separate conclusion should be reached after a thorough reexamination.

FLOORS FOR ITEMIZED PERSONAL DEDUCTIONS

In several areas, suggestions have been made for introducing "floors" for itemized deductions, somewhat akin to the present percentage "floors" in computing the medical expense deduction or even to the "floor" of a flat amount for a casualty loss. Although revenue gain, in addition to a change toward greater progressivity, may be two reasons for that suggestion, achievement of some simplicity is also a factor.

Allowance of a standard deduction (plus personal exemptions) recognizes that a taxpayer has basic sustenance expenditures that should not be taxed. In the alternative, it assumes that taxpayers using the standard deduction have that amount of deductible expenditures, even though the necessity of verification is waived. Either way, a minimum amount is sheltered from tax.

Since personal deductions are provided, by and large, to give due consideration to special burdens borne by some taxpayers and to compensate for extraordinary expenses that diminish an individual's taxpaying capacity, it would be appropriate to limit the deduction to

amounts exceeding the ordinary or bearable portion. Where the deduction serves as an incentive, the marginal rate inducement would still continue.

Simplification objectives would be hampered to the extent that taxpayers engaged in programs to "bunch" their expenses because of a floor. These objectives would not be furthered if taxpayers continued to compile full financial records and make the necessary computations. Experience does indicate, however, that the percentage floor for medical expenses relieves healthy taxpayers from the necessity of coping with the deduction's complications. A floor for any particular deduction would certainly eliminate numbers of taxpayers from claiming that deduction or even seeking to claim it, thereby simplifying the return process for those taxpayers. Any additional complexity for the other taxpayers still able to utilize the deduction would appear to be minimal.

Use of a general, or overall, floor on an aggregate of itemized personal deductions has been proposed. Although the proposal limits "bunching" potential and simplifies final calculations, it fails to differentiate between the nature of the separate deductions. For example, it would clearly blunt the incentive of the charitable deduction for a taxpayer who had no medical expenses or casualty losses. Similarly, it would blunt the income-refining nature of particular deductions. Furthermore, it would probably mean that accounts would have to be regularly preserved and calculated for all of the available personal deductions, since it probably would not be clear until year-end whether the general floor would be applicable. The application of a general floor to items such as home mortgage interest or local property tax is hard to justify on the basis of a percentage of AGI. Since the dominant function for personal deductions is income refinement and the use of an overall floor impairs that function, there will be no further consideration of an overall floor herein.

ANALYSIS OF CERTAIN PERSONAL DEDUCTIONS

The remainder of this paper will attempt to analyze separately certain selected personal deductions in order to consider their purpose, whether their continuation is justified, the nature and extent of their present contribution to complexity, and whether the substitution of a credit or the imposition of a floor is preferable to some other treatment, such as a subsidy. The analysis will assume, to some extent, the existence of substantial policy reasons for some form of governmental benefit in each case.

The deductions to be considered are:

(a) Medical
(b) Casualty
(c) Interest
(d) Taxes
(e) Charitable.

Special attention will be given to the charitable deduction. Outstanding proposals for change will be described, and an evaluation will be made.

Medical Expense Deduction

Code Section 213 allows the deduction of unreimbursed medical expenses in excess of 3 per cent of AGI, plus one half of the cost (up to a maximum of $150) of medical insurance. Amounts spent for drugs and medicines are taken into account only to the extent that they exceed 1 per cent of AGI.

This deduction is of major revenue importance. For fiscal 1977, the revenue reduction is estimated at $2.6 billion. In 1975, medical deductions totalling $11.4 billion were claimed on about 75 per cent (19 million) of the itemized tax returns. The magnitude of the deductions claimed is not surprising in view of the estimate that in 1970 consumers spent 5.9 per cent of personal income for medical care. On the other hand, this deduction has been found to be steeply progressive, in effect constituting a continuously declining percentage of AGI as AGI rises. This progressivity is enhanced by the floor.

The deduction has been justified on the grounds that: (1) extraordinary medical expenses are not generally voluntary consumption expenses and are therefore not within the Haig-Simmons concept of income as the sum of consumption and savings; (2) extraordinary and involuntary medical expenses impair the taxpayer's ability to pay, and thus deductibility tends to preserve horizontal equity; and (3) expenses paid by the taxpayer himself should be removed from taxable income, since these expenses, when paid by an employer (through insurance) or by the government (Medicaid), are excluded from income.

The deduction has been attacked on the grounds that: (1) the nature and extent of treatment is a matter of consumer choice to a considerable degree; (2) it discriminates against the medically insured taxpayer; and (3) it is inefficient and inequitable to the extent that it is a

form of government coinsurance. There is no doubt of its complexity in terms of the difficulties of interpretation and the extent of recordkeeping.

The problems that arise in considering the form of possible changes stem largely from the uncertainty involved in characterizing the deduction as primarily for involuntary, hardship, and nonconsumption expenditures or as a form of partial governmental insurance subsidy. These views bear upon selection of the credit or deduction as preferable treatment. Until national health insurance becomes available and as long as employer and governmental insurance remain nontaxable, the credit does not seem appropriate.

The deduction, however, should be further limited so as to confine it to truly extraordinary expenses. The floor should be raised, say to 5 or 6 per cent of AGI, as proposed by Richard Goode, so as to confine the deduction to clearly excess expenditures. Simplification can be gained by repealing the special treatment for medical insurance premiums and eliminating the special floor for drugs and medicines. With a sufficiently high floor, many more taxpayers would be spared the complexities of this deduction.

Casualty Loss Deduction

Under Code Section 165(c), casualty and theft losses of nonbusiness property are deductible to the extent that the unreimbursed loss from each casualty exceeds $100. Premiums paid for casualty insurance are not deductible.

The reduction in revenue from this item is estimated for fiscal 1977 at $345 million. In 1975, casualty losses aggregating $1.2 billion were claimed on about 7 per cent (1.765 million) of the itemized returns. It has been stated that casualty losses are nearly proportional from $20,000 to the top income levels and are progressive at lower levels.

The deduction has been provided primarily, it appears, as a recognition of an extraordinary involuntary expense that substantially impairs the taxpayer's ability to pay, although it has also been characterized as "negative income" and thus as an income-refining device to achieve horizontal equity. On the other hand, it has been criticized because the unduly low $100 floor permits deduction of some consumption costs (that is, the normal cost of using property), saddles the government with a substantial portion of voluntary self-insurance costs, and is inconsistent with the failure to tax imputed income from the property.

This deduction appears to generate a disproportionate amount of audit controversy and certainly entails substantial costs in assembling verifying data. *Blueprints* recommends abolition of the deduction. Many others have urged the additional imposition of a percentage floor of 3 per cent to 10 per cent of AGI.

A frequent suggestion is to combine the medical expense and casualty loss deduction into a single "extraordinary expense" deduction. The Treasury Department has suggested such a step, imposing a floor of 10 per cent of AGI and maintaining the $100 per occurrence floor for each casualty loss, but eliminating all separate floors for medicines, drugs, and health insurance premiums. There is a great deal of logical merit in this suggestion, since the purposes of these deductions are very similar. In spite of the fact that it would eliminate computing one percentage floor (assuming the future imposition of such a floor for casualty losses), however, it probably would not result in as much reduction of claimed deductions, since a shortfall in one could be made up by the other. Consequently, many more taxpayers could not know until year-end what records to assemble for return purposes.

Simplification seems best served by maintaining the separate deduction for casualty losses but adding a substantial percentage of income floor. Since provision of general government subsidies in this area does not seem appealing, the alternative would be complete abolition of the deduction.

Interest Deduction

Under Code Section 163(a), personal interest on loans for consumption, such as home mortgage and consumer durables, are deductible without limitation (unless used to receive tax-exempt income or to pay insurance premiums). Nonbusiness investment interest is deductible under Section 163(d) only to the extent of investment income plus $10,000 annually, with carryover provisions for excess deductions.

In 1970, an analysis showed that this item was claimed by 89.4 per cent of the taxable returns with itemized deductions. This is less than the percentage of deductions claimed for contributions and taxes, but accounted for over one quarter of the total itemized deductions, ranking only somewhat below taxes. It has been stated that total interest payments are steeply progressive at the lower income levels, slightly progressive in middle brackets, slightly regressive from $50,000 to $200,000, and then progressive again. Home mortgage interest, how-

ever, is moderately progressive over a wide range of income, but more steeply progressive at the lower ranges.

The unlimited personal interest deduction has been allowed since the advent of the income tax in 1913, with little justification beyond assistance to home ownership in the case of home mortgage interest. It has been supported on the ground that it is very difficult to differentiate between business or investment interest and personal interest, as the Canadians seem to have found out. It is also justified as an aid to acquisition of property by those without capital. Furthermore, wealthy persons are able to borrow against investment assets. On the other hand, its need as an incentive to home ownership is vigorously denied in light of the failure to tax imputed income from owner occupation; and it accentuates the discrimination against renters. Essentially, its justification primarily rests upon longevity.

Nevertheless, suggestions have been made for the complete elimination of the personal interest deduction or the retention of only a limited deduction, say $3,600 to $10,000 annually, for home mortgage interest. In this case, there is little movement toward the use of a credit and certainly not toward a floor. Either elimination or a ceiling seems preferred. The factor of simplicity calls for leaving the deduction undisturbed.

Deduction for State and Local Taxes

Under Section 164 of the Code, deductions are provided for all state and local taxes in the nature of income taxes, real and personal property taxes, general sales taxes, gasoline taxes, and certain miscellaneous taxes. The general deduction has been allowed since 1913.

Almost all itemized returns show deductions for some state and local taxes. It has been stated that, in relation to AGI, total deductions for these taxes are roughly constant over a wide income range, although real estate, sales, and gasoline taxes decline in relation to AGI, while state and local income taxes are progressive. In 1972, the total amount of deductions representing state and local taxes was 35.1 billion dollars out of a total amount of itemized deductions of 92 billion dollars.

Gasoline Taxes. The deductibility of this tax, which contributes little to tax complexity, has few defenders, apart from those who point out the hardship to long-distance automobile commuters from its repeal. Repeal has been urged frequently and is currently proposed as a part of the Energy Act. The continuation of the deduction runs

counter to our energy policy and gives a tax benefit to a strictly "user" expenditure. Its repeal would increase revenue by about $700,000 and simplify tax returns. This is one of the few instances in which both simplification and equity considerations point in the same direction, namely, toward the elimination of the deduction.

Sales Taxes. Sales taxes are directly related to consumer expenditures and can thus be characterized as costs of consumption, although they do reduce amounts available for consumption, and can be possibly regarded as "negative income." Five states have no sales taxes; in the other states, the rates and taxable objects are not greatly divergent. If one seeks the formality of equal treatment of the residents of all states, one might look to the elimination of the sales tax deduction. Then, the residents of states with sales taxes would not receive the benefit of a deduction that could not be taken by residents of states without a sales tax. On the other hand, it can be argued that the deductibility of sales taxes furthers the aim of treating all taxpayers equally and compensates the residents of states with sales taxes for the expenses they must incur that are not incurred by their counterparts in states without a sales tax. On the other hand, financing by means of this tax would be deterred by elimination of the deduction if the deduction for income taxes is retained, It is estimated that the repeal of this deduction would result in a revenue gain of 1.5 billion dollars. Although recommendations for repeal have been presented by *Blueprints* and by the panelists at the Brookings Institute conference, there is no general agreement on such a proposal; it failed to gain consensus approval at the conference, and Goode favors its retention. Use of a percentage floor has been suggested but not pressed.

The deduction does contribute somewhat to complexity, but use of approved government tables moderates that factor. In light of the limited present and future use of itemized deductions, however, there appears to be inadequate theoretical or practical reasons for retention of the deduction. Its repeal seems warranted.

Property Taxes. Like home mortgage interest, the deduction for real property taxes is a subsidy to the homeowner. It certainly discriminates against the renter. For middle-income itemizers, it is the largest deduction in amount. It is close to being politically untouchable.

Nevertheless, its repeal has been recommended in *Blueprints* and by some of the Brookings panelists, although Professor Due favored retention. As an alternative, a credit has been suggested, but this has met with little enthusiasm. Certainly, the case for repeal of the property

tax deduction cannot be based to much extent on its potential as a major step toward simplification.

Income Taxes. The deduction for state and local income taxes paid is really a matter of intergovernmental relations. Some accommodation is necessary to avoid duplication of income taxes, and the deduction has been allowed for state and local income taxes from the beginning. Interestingly enough, for most other similar situations, the credit is utilized; but substitution of a credit here would undoubtedly add complexity and would also result in federal revenue loss. Even outright repeal would increase complexity, since it would require a distinction between income taxes paid on business and nonbusiness income. An argument for repeal is based on the proposition that failure to include imputed income from government services provided logically requires disallowance of any deduction. Nevertheless, only Professor McClure, a Brookings panelist, has favored repeal. Here, too, complexity offers little support. Intergovernmental comity is a strong basis for retention of the deduction.

Charitable Contribution Deduction

Present Treatment. The deduction for charitable contributions was added to the income tax law in 1917 in a simple form quite different from the present statute.

The deduction is now allowed for contributions to specified organizations of a charitable nature, provided those organizations avoid proscribed conduct. The amount of the deduction is subject to three limits, relating to percentages of the taxpayer's income, the public or private nature of the recipient organization, and the contribution of appreciated property. A five-year carryover is allowed for contributions exceeding two of these limits. The amount of deduction for contributed appreciated property is restricted according to whether the property is a capital asset, the type of recipient organization, and type of property and its use by the recipient organization. There are special rules for the deduction of partial interests in property. The details need not be presented here, but complexity pervades the process of qualifying for a charitable contribution deduction.

It is the most important itemized deduction in terms of dollars. About 95 per cent (or 24,635,000) of itemized individual returns for 1975 claimed charitable deductions totalling about $15.4 billion. The total revenue reduction from this source is estimated at $5.44 billion

for fiscal 1977. In 1973, it has been estimated that $25.6 billion was given to private charity from all sources, as follows:

Religion	$10.3 billion
Education	4.4
Health	3.0
Social Welfare	2.1
Arts and Humanities	1.7
Other	4.1
	$25.6 billion

The contributions deduction has been found to be steeply regressive in the upper-income brackets, nearly proportional (between 2.4 and 2.8 per cent of AGI) for incomes between $11,000 and $50,000, and progressive for incomes under $11,000.

The deduction provisions are reported to have given rise to numerous audit and litigation controversies. Besides the usual problems of substantiation, there are questions concerning the qualification of the donee; the fair value and, sometimes, the basis of contributed property; the terms of split interest or restricted gifts; the use of tangible personal property directly for the donee organization's exempt purposes; and application of interrelated percentage limitations. The amount of recordkeeping necessary for compliance is often substantial. From the standpoint of complexity, a heavy burden of justification would seem to rest on this particular deduction.

Rationale. Although not often defended on the "lack of ability to pay" rationale, since charitable contributions are almost always voluntary, the deduction has been strongly supported as an appropriate refinement of gross income to reach the properly taxable income. Professor Andrews has suggested that consumption expenses payable out of after-tax income should include only "preclusive" consumption expenditures, that is, those uses of income that prevent other individuals from enjoying the resources consumed or acquired; and since charitable contributions are not "preclusive" uses of income, but rather provide community or collective goods, they do not fall within the concept of consumption income taxable at graduated rates. Professor Bittker has also argued that the deduction is appropriate as an income-defining measure because of the redistributive, rather than consumptive, function of qualified contributions.

The dominant characterization of the deduction, however, is that of an incentive or indirect governmental subsidy for private charitable

activities. It has been classified as a "tax expenditure" for budget-reporting purposes. Professor Surrey has asserted, "The charitable contribution deduction is a special tax provision not required by, and contrary to, widely accepted definitions of income applicable to the determination of the structure of an income tax." Supporters of the deduction appear to avoid a confrontation with this position in their emphasis on the desirability of its operation in light of the financial needs of the recipient charities. The deduction, therefore, is a recognition of government encouragement to charitable giving as a socially desirable activity. Even in this posture, there exists considerable variation in proposals for shaping the form of this government encouragement.

Different Proposals Relating to the Charitable Deduction

Generally. Somewhat surprisingly, the most radical blow for simplication has been struck by the Treasury Department's 1977 *Blueprints,* which advocates the complete repeal of the deduction. The simplification effect is obvious, but the justification appears to be based entirely on the simplistic concept that a "charitable contribution is a transfer between a donor and beneficiaries with a philanthropic organization as an intermediary." Since there is no likelihood or much ability of identifying and taxing the charitable beneficiaries on their receipt of income-in-kind, the logical result is to tax the donor by denying the deduction. This treatment is claimed to be equivalent to the present treatment of gifts between individuals. The analysis is not persuasive, and the proposal's future is highly doubtful.

At the opposite pole are proposals not merely to continue the present deduction but to extend and enlarge the tax benefit. The Report of the Commission on Private Philanthropy and Public Needs ("Filer Commission"), *Giving in America,* recommends that all taxpayers who take the standard deduction should also be permitted to deduct charitable contributions as an additional, nonitemized (or "above the line") deduction. As an additional new incentive for low- and middle-income taxpayers, the Filer Commission recommends a "double" or "150 per cent" deduction so that families with incomes below $15,000 a year be allowed to deduct twice the amount of their giving and that families with incomes between $15,000 and $30,000 be allowed to deduct 150 per cent of what they contribute. The first step is estimated to increase giving by $1.9 billion in 1976 dollars, while the second step could stimulate additional giving by $9.8 billion, at a cost of $7.4 billion in tax revenue lost.

Professor Bittker, who favors an unlimited deduction, recommends repeal of the percentage limits on the deduction, thus extending its scope and restoring the possibility of its use to wipe out completely any taxable income. Since this suggestion would appear to embrace the 30 per cent and the 20 per cent limitations, as well as the 50 per cent limitation, this would be a modest step toward simplicity.

The Filer Commission's recommendation of an unlimited "above-the-line" deduction would obviously greatly extend recordkeeping requirements (as well as all the present statutory restrictions) to a large number of non-itemizers who would claim the separate charitable deduction. The audit burdens would be greatly extended. And, although the Filer Commission defends the present deduction primarily by endorsing its income-defining function, the recommendation for a "double deduction" clearly abandons that concept and grasps at the concept of tax incentive or inducement. Here, too, the future of these proposals is highly doubtful.

The Use of a Floor. We next come to the suggestion that a floor, say 3 per cent of AGI, be imposed on the deduction. This proposal acknowledges that the deduction's major function is to serve as an incentive, for it assumes that a substantial amount of charitable gifts will be made even without any tax benefit but that the charitable contribution activity above a certain level is highly responsive to the tax incentive. For those who endorse the income definition concept of the deduction, the proposal of a floor should appear inequitable, but Professor Bittker is prepared to support it on pragmatic grounds. The Treasury Department, in its 1977 *Tax Reform Option Papers,* considered imposing a floor on the charitable deduction in the form of a floor of 3 per cent of AGI or $5,000, whichever is less, but rejected it. Earlier, the 1969 Treasury studies did propose a 3 per cent floor, coupled with a change in the deduction to a separate, above-the-line status.

More recently, at the Brookings Institute conference, Professor Due has proposed a variable floor based upon increasing percentages of AGI, but that suggestion would clearly compound complexity. Professor Bittker has indicated that a floor would foster simplicity to the extent that some taxpayers itemizing deductions would be eliminated from participating in this one. Some additional complexity would result for those still qualifying for the deduction.

The use of the charitable deduction with a floor is also subject to the substantial defect of inducing "bunching" of contributions into a single year in order to avoid the full impact of the floor. Furthermore,

the floor would increase the discrimination in favor of non-itemizers who do not actually have to make any charitable gifts to get tax relief from the standard deduction, whereas charitable gifts below the floor for itemizers would bear tax (except for that part falling within the "zero bracket amount").

The merit of a floor is not primarily as a contribution to simplification but as a recoupment of revenue from itemizers, without loss of the incentive effect. Professor Feldstein's studies, however, cast some doubt on this assumption. These studies show that in terms of 1970 dollars tax revenue would be increased by $2.727 billion through the imposition of a floor but that total gifts would be reduced by $3.515 billion, constituting a total reduction in gifts of 20 per cent and a reduction of 36 per cent in gifts to education. If this should indeed be the result, the proposal would fail in one of its objectives, namely, to maintain the contribution incentive.

The Use of a Credit. The substitution of a credit, say 25 per cent or 30 per cent of the contributed amounts, for both itemizers and non-itemizers, is an alternative proposal. It appears to be favored by the Council of Economic Advisers and has received support from some members of the Filer Commission. Its claim to merit is that it achieves greater equity by equalizing the after-tax cost of charitable contributions for all taxpayers, regardless of their marginal rates: All taxpayers with a 30 per cent credit will, to the extent that the credit can be utilized, bear 70 per cent of the cost of any charitable contribution.

For those who do not view charitable contributions as items of personal consumption, the proposal is inconsistent with a proper income tax structure. For the rest, the merit of the proposal will depend upon its financial results, for it, like other credits, does not contribute to simplification, particularly in view of the probable need for carryovers and other refinements. (The Treasury Department, for example, wants a floor under the credit to avoid nuisance audits.)

Professor Feldstein has predicted that the impact of a 30 per cent credit, in terms of 1970 dollars, would be a decrease in tax revenue of $2.060 billion and an increase in total gifts of $2.304 billion. Although total gifts would increase by 13 per cent, however, gifts to educational institutions would decrease by 17 per cent. The staff of the Council of Economic Advisers has estimated that there would be an increase in total gifts of 8 or 9 per cent, with a decrease of 3 per cent in gifts to educational institutions; the Treasury Department questions that estimate. In the case of a 25 per cent credit, Professor Feldstein esti-

mates a decrease in tax revenue of $.725 billion and an increase in total gifts of only $.685 billion, with a decrease for educational institutions of 24 per cent.

Using the credit as a substitution for the deduction does not seem to yield adequate results, if the decrease in simplification occasioned by use of the credit is considered to be a substantial factor. The use of a supplemental credit to the existing deduction has also been proposed in order to give greater incentive, but the even greater complexities of this kind of a proposal are clear.

Direct Government Aid to Charities. Finally, we come to nontax alternatives, such as governmental matching grants. A proposed system has been presented in great detail by Professor McDaniel. The charitable deduction would be abolished and replaced by a system of direct federal assistance to private charitable organizations. Each donor's gift would be matched by a predetermined amount from the government to the donee charitable organization. The grant would be made annually in cash, based upon charitable gift information schedules filed with the individual tax return. The program could reflect either a "progressive matching grant" approach (that is, the percentage of federal grant increases as the donor gives a larger percentage of total income to charity) or a "flat matching grant" approach (that is, a constant matching percentage, say 30 per cent, of the amount given). The details of the proposal will not be considered here. Nor will this paper do more than point out possible constitutional objections to direct government payments to religious organizations for their religious purposes.

The proposal's merits have been listed as follows: (1) a more equitable system of expending federal funds for charity, (2) enhancement of pluralism and dispersion of power over federal funds, (3) more effective targeting of the system to actual charitable giving, (4) more efficient incentives to charitable giving, and (5) relief from extraneous changes in the federal tax system.

The matching grant proposal has found few supporters, however. Apparently, this is mostly because of skepticism about the political feasibility of its adoption and, even more so, about the unlikelihood of direct governmental payments without substantial governmental controls. The proposal appears to be a novel one, unmatched by any governmental program in other countries. The possibility of its consideration and adoption in this country exists only because of this country's unrivaled existing generous charitable deduction, together

with the existence of some dissatisfaction with its operation. Here, too, the factor of simplification is difficult to appraise. Elimination of the tax deduction would, of course, be a substantial step toward simplification; but the administrative problems of operating a matching grant system would appear to result in equivalent complexity.

Conclusion. In very brief summary, there appears to be little possibility for simplification of the individual income tax by eliminating completely itemized individual deductions, with the possible exception of sales taxes and gasoline taxes. On the other hand, although mechanical simplification is not advanced, some real reduction in recordkeeping and audits could be achieved by increasing or instituting floors for medical expenses, casualty losses, personal interest, property taxes, and, possibly, charitable contributions. In all cases, there are practical difficulties, and, in some cases, there are theoretical objections. Nevertheless, some of these changes should be tried as part of a program of general rate reduction.

F

Capital Gains and Simplification

Frederic W. Hickman

AN INTRODUCTION AND SOME CONCLUSIONS

Capital gains is often cited as one of the greatest complicating features of the federal income tax system. Whether that is really true is the principal topic of this paper.

The most popular prescription offered to simplify capital gain is to tax it as ordinary income—a fundamental change. Much of the potential for simplification, however, lies in capital gains provisions that are less central, such as the minimum tax, the preference provisions of the maximum tax, and the rules for carryover of basis at death. Each of those provisions standing alone is a major complication.

Looking forward in time, it is as important to prevent new complications from emerging as to reduce those currently existing. Many critics of the existing system believe that the basic defect lies in the failure to tax unrealized appreciation. Thus there are recurrent proposals to tax unrealized appreciation—to tax all of it each year, to tax as much of it as arises from marketable securities each year, to tax it at intervals greater than a year, to tax it at death, and to tax it at the time of gift. Each of those proposed changes has significant implications for simplification.

In addition, the high rate of inflation in recent years has caused existing accounting rules to grossly mismeasure real gains by overstating them and real losses by understating them. The *tax* presently levied often exceeds the total real *gain*. It then becomes a 100 per cent tax on the income, however defined, and, in addition, a partial confiscation of principal. Pressures to change the existing rules so that they will correctly measure real income have understandably been

* Frederic W. Hickman is a member of Hopkins, Sutter, Mulroy, Davis & Cromartie, Chicago, Illinois.

mounting. These, too, if enacted, would have major implications for simplification.

To lend a sense of destination to the lengthy discussion that follows, I report some of my own broad conclusions at the outset.

(1) The long-standing controversy over the taxation of capital gains centers on notions of fairness and abstract concepts of "income" on which reasonable men (reasonable, at least, in other contexts) hold passionate and conflicting views. Arguments about simplification are usually secondary arguments, advanced not for their own sake but for the purpose of buttressing some primary argument that capital gains should be taxed more or less than they presently are.

(2) Those realistically concerned with eliminating complexity in the tax law will avoid getting lost in dry logic and will pay heed to the realities of the political process. The present system of taxing capital gains is a compromise between conflicting philosophies. In the current climate of opinion, any revised system will also be a compromise. Compromises inevitably breed complications, and new compromises will breed new complications.

(3) Computations of "gain" lead inevitably to major complexities, whether the gain is capital or not. Receipts and receivables must be matched against outlays and commitments for outlays, often over extended time periods. Determining which items are to be taken into account cannot be made simple. Whether particular items of gain, once determined, are to be taxed at different rates is a further complication, but it is the tail and not the dog. Many, if not most, of the elaborate tax rules applicable to items of capital gain relate to whether a gain will be deemed to be "realized" and how the gain will be measured, and would be substantially the same regardless of the rate at which the resulting gain would be taxed.

(4) One cannot consider the goal of simplification without also considering whether the substantive changes required to produce it are "right" or "wrong." Simplification is usually attained by foregoing precision. Complexity is itself a form of injustice, and the need to weigh competing considerations is always present. Opportunities to achieve major simplification may justify some rough justice in substantive aspects. But major substantive injustices are too high a price to pay for simplification, if the simplification is only minor.

(5) The most egregious complexities in the present capital gains system have resulted from the efforts of those who oppose the present capital gains rules to confine them to the narrowest facts possible or

to increase the effective rate of tax in backdoor ways. The preference provisions of the minimum and maximum tax and the carry-over of basis at death rules are prime examples of this.

(6) Serious analysts are nearly unanimous in the view that the computation of gain without an inflation adjustment mismeasures "real" gain by overstating it and, to that extent, raises the effective rate of tax. Nonetheless, many oppose correcting this defect because they do not favor *anything* that further reduces a tax that they believe is already too low. They tend to slide over individual inequities and concentrate on aggregates, contending that the overtaxation that results from overstating real gain is balanced, in the aggregate, by an undertaxation that results from using preferential rates for realized gain and not taxing unrealized appreciation at all. Sometimes they also argue (a) that it would be "unfair" to correct the mismeasurement of real income in the case of capital gain without correcting other mismeasurements caused by inflation, especially the mismeasurement arising in connection with debt and interest and (b) that indexing for capital gains would introduce too many complexities. Taxing capital gains at ordinary rates would not necessarily pave the way for inflation adjustments. Many of those who view the failure to tax unrealized appreciation as the basic inequity would still oppose making inflation adjustments.

(7) Taxing capital gains as ordinary income is likely to produce only minor *net* simplification, at best. It may produce complexity that is either greater or more difficult to live with because it is new and unlearned. The tension between ordinary income and capital gains would be reduced, but the tension between realized gain and unrealized appreciation would be intensified. Opponents of capital gains treatment would remain unsatisfied with the treatment of unrealized appreciation, and complex rules would need to be retained or new ones devised to prevent perceived "inequities" arising from the tension. Limitations on capital losses, for example, would surely be retained so that problems of defining capital assets (or some other new category of asset) would remain.

(8) The most intractable complexities attending capital gain arise from the fact that realized gain is taxable and unrealized appreciation is not. But taxing unrealized appreciation would create a whole new set of complexities. Alternatively, not taxing gain would put more pressure on existing complexities and be politically unacceptable. Alas, as in most human affairs, no truly simple system of taxing gain appears to exist.

HISTORY OF CAPITAL GAINS TREATMENT

To assess the prospect of simplifying by changing the capital gains rules, one must start with the reasons that gave rise to the current rules. Whether abolition of the current rules would produce *net* simplification depends upon whether the reasons that gave rise to the rules are rejected or are simply satisfied in other ways. The political realist will be sensitive to the probability that reasons underlying the current rules, even if deemed unworthy by the intellectual community, are likely to be given at least limited expression if they are widely held.

Since 1921 capital gains have been treated as "income" but have been taxed at lower effective rates than other income. For individuals, that result has been achieved principally by excluding half of the gain from the taxpayer's income before applying regular rates, thus producing an effective rate equal to half the nominal rate. For many years, there was a maximum effective rate of 25 per cent, which is now applicable to only the first $50,000 of gain.

History is not explicit about the original reason for the lesser rate. It appears to have been a compromise with those who believed that capital gains are not really "income"—a widely held view, as evidenced by the fact that most foreign systems did not treat capital gains as income at all.

Today, tax professionals do not worry much about the concept of income. Most assume that everyone knows what income is and that the only issue for debate is whether all the items that are conceptually income can be practically incorporated into a tax basis that must be administered by ordinary human beings.

This was not always the case. Beginning in the late 19th century and continuing for nearly half a century, there was extended debate about the nature of "income." The debate seems to have culminated or, perhaps, "petered-out" with the writings of Henry Simons and, in particular, with the publication in 1938 of his book, *Personal Income Taxation*. His definition of income (referred to generally as the "Haig-Simons" definition) is described in that book and is the definition most widely accepted today. It defines personal income as the sum of consumption and accumulation, or the money value of the net accretion to one's economic power between two points in time. The definition clearly encompasses capital gain.

In the four decades since publication of this book, economists have been largely preoccupied with matters of macroeconomics. An occa-

sional voice has suggested that the concept of income needs to be reviewed in the light of macroeconomic concepts that have developed in the interim, but most economists seem content to proceed with the Haig-Simons definition.

In the earlier debate over the nature of income, the status of "capital gain" was a major issue. Notwithstanding the mischief that metaphors play in the process of straight thinking, the example of a tree and its fruit has been durable and useful.

The value of the tree as a capital, income-producing asset is equal to the present value of its future income stream, that is, the apple crops that it will produce in future years. If it is expected that the tree will produce more fruit or that the price of the fruit will increase, the value of the tree will increase, producing either unrealized appreciation or realized "gain." Similarly, if inflation causes a rise in the general price level, the nominal price of apples will increase, producing a larger dollar stream of income that, when capitalized, will produce a nominal dollar increase in the value of the tree, although not a real increase. In economic terms, these gains reflect the capitalization of larger income streams, whether real or only nominal. Finally, the value of the tree may increase, even though it produces the same apples that sell for the same price if preferences change and more people decide to save their money and buy trees, thus pushing up the demand for and the price of trees and lowering the return. In economic terms, that gain reflects a change in the capitalization rate of the future income stream.

The Arguments Over "Double Counting" and the "Acceleration" of Tax

If the increase in value of the tree, as a capital asset, consists of an increase in the dollar value of a future stream of apples, a tax on the present increase in value is, in reality, a tax on the present value of future apples. But when the apples, in fact, arrive in later years, they will be treated as income and tax will again be collected.

Economists have argued sporadically about the implications of this argument; but they have not wrestled with it recently in the context of the developments in macroeconomic theory, which emphasize that the real income in the system as a whole consists of the apples as they are, in fact, produced.

If, in reality, the metaphorical tree is a depreciable asset, then any

appreciation that is realized and taxed will become a deductible cost of producing the apples in the future. In such a case, the increased income reflected in capital gain will cause lesser income later when the gain is transformed into depreciation deductions. Over the useful life of the tree, the same aggregate income will be realized, and the same aggregate tax will be paid.[1] The bulk of the tax, however, will be collected at the "front end," rather than ratably as the apples are produced and sold. Viewed in that way, the result is an acceleration of tax.[2] Just as a deferral of tax is a benefit to the taxpayer and a cost to the government, an acceleration is the reverse, that is, it is a cost to the taxpayer and a benefit to the government. The value of a deferral or an acceleration as a cost or benefit, as the case may be, depends upon the time period over which it occurs and upon the discount rate assumed. In the case of short-lived, depreciable assets, the value of the acceleration of tax may be slight. For long-lived or nondepreciable assets, the value will approach the amount of the tax itself. Thus when dealing with nondepreciable assets, such as corporate stock, the value of the acceleration as an additional cost to the taxpayer and a benefit to the government is nearly equivalent to including the income twice in the tax base.

The foregoing line of arguments raises a number of theoretical questions. Does taxing capital gain, which represents capitalized future income, really tax more income than there is in the system at the time of the tax, that is, do the dollars in the tax base exceed the value of all the apples (and similar items) produced in the period in question? Or are the number of taxpayers who are individually better off because they own a larger stream of expected earnings offset in some manner by taxpayers who are worse off in equal degree (so that the total dollars taxed equals the current apples after all)? Should the answers to these questions make a difference in regard to how individuals are taxed compared with each other? Should we not, in any event, tax realized gain because otherwise the wrong party will pay the tax, that is, the purchaser who, in fact, pays for the income? But if we do, should there be an offsetting tax reduction somewhere else? If there is, in fact, an undesirable element of acceleration of tax, could it be roughly offset by permitting the buyer to exclude income from the assets until his basis has been recovered? Does the seller of an

[1] That arithmetic is illustrated in Goode, *Economic Definition of Income*, A Comprehensive Income Tax 11-12 (1977).

[2] Note that this is a much narrower argument than the arguments (1) that all income from capital should be taxed twice, (2) that unrealized appreciation is not income in nature and should not be taxed, or (3) that there are implicit capital losses that attend and offset any "deferral" benefits.

appreciated asset incur an "implicit" tax because the market, having capitalized the disadvantage of incurring tax on sale, causes him to realize a lesser selling price than he would otherwise realize? (This would occur in a manner similar to that which occurs when the market capitalizes the tax advantage of exemption for municipal bonds, causing their price to be higher and thus exacting an implicit tax of about 30 per cent, reflected in a yield 30 per cent less than the yield on taxable bonds.) If they do pay an implicit tax, is it then inequitable if the explicit tax is less than for other income? Regardless of the degree to which individuals are better off when compared with each other, if the income stream is, in fact, taxed more than once, will that cause people to plant fewer trees and seriously restrict the total supply of apples in future years?

Haig-Simons theorists doubtless have or can find answers to those questions that support their view. Recent economic literature, however, does not deal convincingly with these issues.[3]

The present system of taxing capital gains does not deal squarely—either way—with the theoretical arguments concerning whether such gains should be taxable income. It is a compromise. It does not go as far as many foreign systems, which have exempted capital gain entirely. It exempts unrealized appreciation from tax and taxes realized gains at half rates. Like most political compromises, it satisfies no one, leaving the rules vulnerable to erosion in either direction as the political tides ebb and flow.

Those in the Haig-Simons corner believe that tax should be imposed on both realized and unrealized gains and that the nontaxation of unrealized appreciation and the preferential rate for realized gain are inequities and should be corrected. Others believe, either intellectually or emotionally, that capital gains should not be taxed as income at all; resent the tax on realized gain; and think that it should be reduced. The concern for greater "capital formation" has infused

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[3] It has been suggested, for example, that the tax acceleration effect described above is only another facet of the characteristic of any income tax that amounts saved out of "income" are taxed once when the income is realized and that subsequent amounts of income from those savings are taxed again when they are realized. That may be true if one assumes that "income" properly includes capital appreciation resulting from a revised valuation of a future income stream. But it is that assumption which is in issue. Similarly, it is argued that it is "unfair" to treat "savings" from unrealized appreciation differently from other "savings." Perceptions of fairness are critical in any tax system, but they do not answer the analytical questions raised. In any event, it seems probable that this particular perception is not shared by the bulk of taxpayers. Nor is it clear that "savings" from unrealized appreciation are a component of "savings" as that term is more conventionally used, at least in a macroeconomic context. The purpose here is not to reach a conclusion on the economic issues, but only to argue that they need to be reexamined.

new vigor into this position, as the label "capital gains tax" suggests to the public that it plays a dominant role in that process. (It is, in fact, only a modest piece in that larger puzzle.)

The common voter is unaware of all of these niceties and is not interested in the theoretical arguments of either camp, unless they somehow translate into a tax reduction for him. I will hazard the guess that a poll of ordinary voters would reveal that their views are conditioned by existing practices and that they regard realized gain as income, which should be treated like any other, but do not regard unrealized appreciation as income (at least not on their own homes).

These differing views are not on the verge of resolution; the views of many approach religious conviction. Even if the theorists were to resolve their differences tomorrow, a new generation with "clean slate" minds would have to be educated before we could expect to arrive at anything approaching a political consensus.

In the political process, this kind of deep division means compromise, and compromise usually means the worst of both worlds as far as simplification is concerned. The realist must be profoundly pessimistic about the chance of getting a clean and simple system, even if an administration were able to formulate one and willing to propose it.

Much of the complication we now have in the system with respect to capital gains is attributable to these deeply felt opposing views. The minimum tax and the portion of the maximum tax relating to preferences are prime illustrations. Better than 85 per cent of the "preferences" involved in those taxes consist of the excluded portion of capital gains. The additional taxes imposed on individuals by the preference provisions are, in fact, an indirect tax on capital gains. Although the taxes were originally proposed as mechanisms to make high-income taxpayers pay some reasonable amount of tax, they are singularly ill-designed to achieve that result. They are a testimonial to the degree to which the Haig-Simons theory has created the crusading conviction that the present method of taxing capital gains is a "loophole for the wealthy," and to the ingenuity with which those enlisted in that crusade seek to increase the tax on capital gains in every practicable way.

"BUNCHING" OF INCOME

A reason often advanced for the lesser rate of tax on capital gain is that gain often represents increments in value accumulated over many years and that "bunching" all those increments into a single taxable

year would throw a large part of the gain into unduly high brackets. The bunching argument does not appear to have played a role in the initial legislative decision to tax capital gains at lesser rates. Proponents of the Haig-Simons concept of income tend to be unconcerned about this asserted inequity, presumably because they view it as a reasonable exaction for the privilege of not paying tax on unrealized appreciation.

Since 1969, capital gains have been eligible for income-averaging. In order to use the averaging provisions, the taxpayer must forego the benefits of the maximum tax and the alternative tax on the first $50,000 of capital gain, which takes away the value of averaging for many. Nonetheless, to the extent that bunching is a problem, the 50 per cent exclusion responds to it in a most erratic way. It can be handled better, although less simply, by averaging provisions than by a flat 50 per cent exclusion; and the enactment of the averaging provisions substantially vitiates the force of any bunching argument.

"LOCK-IN"

Another argument for the present capital gains provisions turns more on practicality than on theory. The argument is that a high rate of tax will cause gains to go unrealized, thus "locking in" unrealized appreciation. High rates could in that way produce less tax, and, from the point of view of Haig-Simons proponents, less tax means more inequity. Would high rates in fact cause less tax? That would clearly not be the result under all tax rate assumptions. (A zero rate of tax, for example, could never produce more tax.) It might be true, however, within ranges of rates. No reliable empirical data exists either way, and proponents of both views can and do argue to suit their predilections.

There is a consensus that "lock-in" tends to produce a misallocation of resources and a loss in market efficiency, although the consensus evaporates on the question of whether those disadvantages are significant in amount.[4]

The "lock-in" effect is entirely a function of the difference between no tax on unrealized appreciation and a substantial tax on realized gain. But no one is seriously proposing to tax unrealized appreciation,

[4] "Lock-in," however, does not, as many laymen believe, directly reduce "capital formation." Capital is not created by "unlocking" appreciation. There will be both a purchaser and seller for every transaction. As the appreciation is "unlocked" by sale, the seller will have more with which to make new capital investments, but the purchaser will have less.

and as long as it is untaxed, increasing the tax on realized gain will increase the "lock-in." As long as taxpayers can completely avoid tax by declining to realize their gains, respectable arguments can be made both for and against the proposition that the present half rate produces more overall "equity," more revenue, and more economic efficiency than taxation at ordinary rates.

INFLATION

In recent years, inflation is increasingly pointed to as the principal justification for the capital gain rules. Again, there is no evidence that it was a factor in the original enactment of those rules. Virtually all analysts, however, concede that inflation today causes problems of income overstatement that the lesser capital rates tend to mitigate. In a serious inflationary period, the use of historical cost figures causes a serious mismeasurement of the real economic gain or loss on transactions. The greater the rate of inflation and the longer the elapsed time between acquisition and disposition, the greater is the overstatement of gain or the understatement of loss.

The mismeasurement occurs whenever a cost incurred in one period is matched against receipts received in another period. Take, for example, a taxpayer who pays $100 for an asset in year 1 and sells it for $200 in year 10 after there has been 100 per cent inflation. Current accounting practices mismeasure his income as $100. In fact, he is no better off with $200 in year 10 than he was with $100 in year 1 and has had no real income at all. Similarly, an individual who lends $100 in year 1 and is repaid $100 in year 10 will have neither income nor loss under current accounting practices. But he will fall $100 short of maintaining the value of his principal, that is, he will have a real loss of $100.

These same principles apply to inventories (which consist of assets purchased in one period, to be sold in another) and to depreciation (which represents that portion of an asset acquired in one period that is sold in the form of goods produced in a later period).

The Treasury estimated several years ago that roughly 30 per cent of the aggregate nominal appreciation in listed stocks was illusory appreciation caused by inflation. On that basis, a capital gains tax of 35 per cent on a nominal gain of $100 would produce a tax of $35. Since the "real" gain is only $70, a 35 per cent tax on nominal income

becomes a 50 per cent tax on real gain of \$70.[5] The overstatement of gain has doubtless grown since that estimate and will grow still more if inflation continues at present rates.[6]

Inflation adjustments have nonetheless been resisted by many who concede the mismeasurement of income that inflation produces. Those who believe that capital gains are already taxed too lightly are reluctant to concede any adjustments that would further reduce aggregate taxes on capital gains, even though they recognize that particular taxpayers may be heavily penalized by having to pay tax on gains that are totally fictitious.

Those who oppose indexing for gains and losses sometimes assert that it would be "unfair" to make inflation adjustments for capital gains or depreciation without also making adjustments for debtors and creditors and that since it is too difficult to adjust for the latter, nothing should be done to either.[7] But it is far from self-evident why Congress should refrain from correcting one error because there is no practical way to correct another. It is also argued that adjusting gain for infla-

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[5] Similarly, if the minimum and maximum taxes raise the nominal rate from 35 per cent to the potential maximum of 49.125 per cent, the effective tax on real income will rise to 70 per cent.

[6] Note that the arguments for indexing gain, inventories, and depreciation are fundamentally different from the arguments for indexing tax brackets and deductions. In the former cases, inflation causes a mismeasurement of real income, and indexing is required to determine accurately the amount by which the taxpayer is, in real terms, better off. In the latter case, there is no mismeasurement of income, and the amount by which the taxpayer is better off is known. Indexing is advocated not because it corrects a mismeasurement but because it prevents the effective rate of tax from rising automatically as the same amounts of real income are thrown into higher brackets.

[7] It seems generally agreed that indexing present outstanding debt and interest obligations would introduce inordinate complexity. It would, however, appear to be reasonably simple to deal prospectively with those items by providing for new debt instruments under which the principal (and thus the amount of annual interest and the amount to be repaid on maturity) would be adjusted upwards annually without creating either a deduction for the debtor or income for the creditor. In any event, it should be noted that there is a fundamental difference between gain and depreciation, on the one hand, and debt transactions on the other hand. In the case of gain and depreciation, sellers and buyers meet in one-time transactions. In the case of debt transactions, on the other hand, there are two parties to the transaction throughout the period over which the inflation occurs, for whom opposite adjustments would cancel each other out. Thus the failure to adjust for inflation does not increase the total tax burden on the transaction. It affects only the amount of real income to be paid by one party to the other, which is something the parties can rearrange among themselves in the marketplace, in accordance with their estimates of the degree of inflation and taxation that will occur in the future. This is not a totally satisfactory answer if the parties guess wrong. But in any event, there is a substantial amount of self-help available, and the tax system is not imposing a tax on more income than actually exists in the system, although it may be allocating the tax in unexpected ways. It is also important to note that since an inflation adjustment for debt involves equal and opposite adjustments for the borrower and the lender, there would be no revenue effect for the Treasury in providing such adjustments, unless and to the extent that the marginal tax rates of borrowers and lenders are, in the aggregate, substantially different.

tion would introduce undesirable complexity. These two arguments are doubtless advanced with sincerity by many, but it is difficult to escape the impression that they are secondary to a more fundamental concern that capital gains are already taxed too favorably.

POTENTIAL FOR SIMPLIFICATION—IN GENERAL

Tax complexity can be measured in at least two ways:

(1) The number of persons to whom complicated rules apply and the number of occasions on which these rules are applicable, and

(2) The complexity of the rules themselves.

Tax professionals, particularly the thousand or so individuals whose livelihoods are concerned with business transactions that are complex, even without regard to taxes, have hold of that part of the elephant in which capital gains is prominent. They observe extraordinarily complex rules, affecting a preponderance of the persons in the important, but thin, stratum in which they operate. Because of the frequency with which they touch the subject, they are prone to the view that the whole tax system would be much simpler if capital gains were taxed as ordinary income. It is a testimonial to their sincerity that so many of them stand ready to eliminate provisions that they believe play such a central role in their livelihoods.

Having lived for 25 years myself in that specialized world, however, I venture to suggest that, in most instances, capital gain is only one aspect of transactions that have many other tax aspects and that would be complex with or without the capital gains aspect. That is not to say that capital gains are not complex but only that elimination of capital gains is no prescription for producing tax simplicity in these kinds of cases.

Further, I venture the observation that the number of persons and transactions affected by the rules is limited. Unquestionably, the difference between the capital gains rate and the ordinary rate puts a good deal of pressure on certain kinds of transactions; and the lesser rate provides an impetus for transactions that might otherwise not occur at all. Additional transactions are additional complications. But they are not necessarily undesirable. If everyone stayed home and entered into no transactions at all, life would be "simpler" but doubtless less attractive.

Even in litigated cases, which typically involve high-bracket taxpayers and complex transactions, the number of cases centering on

capital gains issues is a minor fraction of the total. Volumes 65 and 66 of the Tax Court reports, the last two bound volumes, report 203 cases. Twenty cases, less than 10 per cent of the total, involved capital gains issues directly. Taxing capital gains as ordinary income would have eliminated only 8 of those 20 cases. Of the remaining 12 cases, 5 involved capital losses. The balance involved situations in which either (1) the capital gains issue was inextricably bound to other issues that would have had to be decided anyway (such as determinations of gain, basis, or realization) or (2) capital gains treatment, if abolished, would be replaced by some new rule that would raise a similar issue (such as the rule for capital gains treatment on lump sum distributions from profit-sharing plans, which has already been replaced by another, more complex, averaging device).

In any event, unless we are prepared to tax unrealized appreciation currently, which would entail enormous additional complexity, we cannot avoid the tensions produced by disparities in rates and the complications caused by tailoring affairs so that they are governed by the lesser, rather than the greater, rate. It is true that taxing capital gains at ordinary rates would eliminate rate differentials between classes of realized income. But it would double the differentials between realized gains and unrealized appreciation! That, in turn, would put vastly more pressure on the rules that relate to the recognition or nonrecognition of gain, which are among the most complex rules in the Code.

In a tax on income, there is no way to avoid questions of whether gain or loss has been realized, how they are to be measured, what items are to be matched against each other in which periods of time, and when the gains or losses are to be reported. When all those things are determined, whether the items are to be classified as ordinary or capital is an additional complication, but it should not be overestimated.

But even more significant is the fact that the complexity arising from capital gains affects relatively few persons and is not the kind of complexity that threatens to strangle our system. More than 80 million taxpayers file returns. Only 7.5 million—about 9 per cent—report capital gains or losses. The vast majority of that 9 per cent incurred those gains in transactions that were simple and uncomplicated, at least so far as their involvement was concerned. Most of them will have no difficulty with the capital gains portion of their returns. Less than half will even need to compute the alternative tax. Increasingly, taxpayers can even avoid the arithmetic by using computerized tax services. They will, of course, need to know the cost of the assets sold, whether they were acquired more than nine months before the

date of sale, and the costs and proceeds of the sales. These items are not always easy to identify, but they are requisite in any income tax system that taxes gains, regardless of whether special rates are applicable.

On the whole, the basic capital gains rules are neat and clean. Complexities are confined to a relative handful of taxpayers, usually in the upper-income brackets. They generally arise because the taxpayer's affairs are complex in a complex economy, and these taxpayers can usually afford to retain members of the relatively small corps of trained specialists who are competent to deal with the complexities.

TAXING CAPITAL GAIN AS ORDINARY INCOME

If Congress were to (1) eliminate the distinctions between capital gains and losses and ordinary gains and losses; (2) do so completely; and (3) resist the temptation to provide exceptions, limitations, and transition rules or to enact other provisions to mitigate or modify the results of elimination, there would doubtless be substantial net simplification, although, for the reasons explained above, it might be modest in relation to the system as a whole.

The largest block of rules that could be eliminated are the definitional rules that determine whether property is capital gain property or ordinary income property. They are found primarily in Subchapter P of Chapter 1 of Subtitle A of the Internal Revenue Code. Most of that Subchapter could be eliminated. In my edition of the Internal Revenue Code, which is 2⅜ inches thick, Subchapter P accounts for $^1/_{16}$th of an inch—or about 2½ per cent. Portions of other sections distributed throughout the Code could also be deleted. Those deletions could make life somewhat simpler for tax lawyers and accountants. One must keep in mind, however, that probably 90 per cent of the Code relates to problems encountered by perhaps 10 per cent of the taxpayers, and only occasionally at that. The capital gains provisions that are candidates for deletion fall in this category.

But even this degree of simplification is too much to expect, for no student of the legislative process would expect Congress to make the kind of clean sweep described. Many, including myself, would expect Congress to write new rules, at least as long as those deleted. Just "for beginners," one would expect new rules to deal with the illusory gain produced by inflation and with capital losses.

Inflation Adjustment

If capital gains were no longer taxed at preferential rates, there would be overwhelming and legitimate pressure to write new provisions to adjust for inflation. The present 50 per cent exclusion is a cushion—inexact, but nonetheless a cushion—against the gross mismeasurement of real income that presently occurs. Even with the exclusion, many individuals find the capital gains tax confiscating not their gain but their original investment. Without the exclusion, the situation would be intolerable. In its September 2, 1977, *Option Papers,* which proposed to tax capital gains as ordinary income, the Treasury grudgingly recognized this practical fact by endorsing a basis adjustment for assets held for more than 10 years.

Capital Losses

The bare logic of eliminating all capital gains/ordinary income distinctions requires that capital losses be fully deductible. But Congress would be most unlikely to permit full deductions for losses because taxpayers could, and doubtless would, realize their losses, but decline to realize their potential gains. Many more losses would be realized than at present, and, in periods of market decline, the loss of revenue resulting from loss deductions could well exceed the revenues from gains realized during the same period. The possibility that wealthy taxpayers would, in many cases, eliminate all tax liability would be political anathema.

In order to prevent these results, Congress might retain the existing classification between capital assets and other assets for loss purposes only. That would require retention of most of the definitional rules that are the source of much of the complication. The rules themselves would not be much simplified, but there would be simplification because they would be applicable to far fewer transactions, that is, only to losses.

Another possibility would be that new classifications and new limitations would be devised for loss purposes. It has been suggested, for example, that losses might be allowed without limit on all assets except "marketable securities." Losses on marketable securities would then be allowed against ordinary income only to the extent that they exceeded gain, plus unrealized appreciation on these securities. There would, of course, be new definitional problems concerning what consti-

tuted "marketable securities" to replace the problems of defining "capital assets." Tax lawyers and accountants would then set to work turning marketable securities into nonmarketable securities (doubtless at some considerable loss to economic efficiency) in order to minimize the exposure to after-tax losses. All taxpayers with "marketable securities" would be required to keep cumulative inventory accounts for their marketable securities, reflecting changes in valuation and the adjustments to basis occasioned by those losses that were offset against unrealized appreciation. There would doubtless be allocation rules designed to prevent the taxpayer from applying these losses to unrealized appreciation in the manner most advantageous to him. Additional rules would be required to deal with taxpayers who owned these securities indirectly through trusts, corporations, and partnerships. New economic distortions would be created by discriminating, still another time, against the securities of publicly owned corporations and by discriminating in favor of ranches, oil wells, farms, and private businesses. (The urge of populist legislatures to discriminate in this fashion is ironic in view of the fact that the gains discriminated against are probably more apt to be held by less wealthy individuals than the gains favored.) Theoretical arguments can be advanced for this kind of a system, but they do not rest upon the promise of greater simplicity.

"CONSTRUCTIVE" REALIZATION OF GAIN

Two proposals for "constructive" realization of gain are recurrently proposed. The first proposal is that a donor of appreciated property be treated *as if* he had sold or exchanged the property, thus realizing gain. The second is that a decedent be treated *as if* he had sold or exchanged appreciated property in his estate at the time of death.

Ambiguities and uncertainties are always produced by rules prescribing a result "as if" an event had occurred, when, in fact, the event has not occurred. When a particular event has occurred, the circumstances surrounding it can be ascertained where relevant; but if it has not occurred, the surrounding circumstances must often be imagined. "Constructive event" rules create greater or lesser mischief depending upon their context.

No genuine problem of simplification is involved in the proposal for constructive realization of gain on gifts. We have operated for decades with a carryover of basis rule for gifts, and no significant complexities are apparent. Ascertainment of the basis carried over does not present the problems it does in the case of decedents' estates be-

cause the donors are still living and tend to be upper income taxpayers with better than usual records and because the determination of basis is usually confined to a limited group of the donor's assets. If the rule were replaced by a constructive realization rule, the donee would still be required to look to the donor's tax records to establish his own basis.

There may be substantive reasons why a constructive realization of gain on gift rule is more desirable or would be more desirable in the context of some major overhaul of the system. But under the present system, it cannot be justified as contributing significantly to simplification.

The situation with respect to the realization of gain at death, however, is quite different. Prior to 1977, gain or loss was not realized at death, the property was subject only to estate tax in the decedent's estate, and the beneficiaries took a tax basis equal to the estate tax value finally determined. That system was infinitely simpler than either constructive gain at death or carryover of basis at death.

In the Tax Reform Act of 1976, the system was changed to a carryover of basis system, thereby introducing probably the greatest new complexity in the tax law in years.

A constructive realization of gain at death rule would be enormously simpler than a carryover of basis rule. But neither taxpayers nor the tax bar is clamoring for the simpler rule. The views of practitioners on simplicity are obscured by the depth of feeling with regard to the more substantive issue. Taxpayers with large estates and the practitioners who represent them usually find the carryover of basis rule more palatable than a capital gains at death rule because the carryover rule appears to keep the tax collector from the door for the longest possible time. In a great many cases, their arguments with respect to simplicity are tailored to support that view. They take the position that both systems are inordinately complex and are unwilling to concede that the carryover of basis system is substantially more complicated.

Under either rule, at the time of death it is necessary to determine what the taxpayer originally paid for the property, either to compute the gain at death or to determine the basis to be carried over to the estate and the heirs. Identifying the original cost is often difficult, even for a living taxpayer. That is particularly true if the taxpayer must worry about household furnishings, personal effects, home improvements, and similar assets, as many do not have records of what they pay for those items. The task is vastly more difficult when the taxpayer is dead. With a capital gains at death rule, however, the

numbers, once determined, are used to compute tax and can then be forgotten. Under a carryover of basis rule, on the other hand, the numbers must be kept and used for successive generations, as long as the property remains in the family.

A much more serious problem arises under a carryover of basis rule from what might be called the "management" of potential tax liabilities. In deciding what assets to sell and what assets to distribute to which heir or beneficiary, executors and administrators must take account of the fact that each asset carries with it a potential income tax liabilty. An heir who receives stock worth $10,000 with a zero basis has a much less valuable asset than the heir who receives stock worth $10,000 with a $10,000 basis. There is, however, no satisfactory way to put a value on that difference because no one can tell in advance when there will be a sale triggering the tax liability and what tax bracket the heir will be in at the time. Similarly, as the executor decides what assets to sell to raise money for taxes, expenses, and cash bequests, he will find his decisions affecting the estate's tax liabilities and the amounts left to distribute, which may, in turn, create conflicts among different classes of legatees. Other conflicts arise as the executor decides what assets to distribute to whom. Conscientious tax planners must worry endlessly about using and distributing high- and low-basis assets in such a way that total taxes will be minimized. Already, elaborate computerized systems are being devised and merchandized to deal with these problems. Ordinary practitioners find that the probate process, under these circumstances, exceeds their competence, and taxpayers are required to retain more specialized and more expensive counsel. All of this adds enormously to the effort and the cost involved in planning and administering estates.

The carryover of basis at death rule is a classic illustration of how tax simplification almost invariably takes a backseat to substantive provisions. Estate tax professionals would undoubtedly vote overwhelmingly and sincerely for "simplification," as long as they were dealing with simplification in the abstract. In the concrete, however, they are apt to prefer, and to lobby hard for, provisions of great complexity, when they believe that it will lessen their taxes or the taxes of the clients with whom they are identified.

TRANSITIONAL RULES

If the tax rate on capital gains were doubled overnight, those individuals holding appreciated property would immediately incur large

losses in capital values. Their assets would be worth less, just as their portfolios would be worth less if the market declined.

The magnitude of those losses would cause major dislocations in the economy, as individuals readjusted abruptly to changes in financial position. As feelings of inequity are most intense when individuals lose something that they presently possess (as distinguished from being deprived of a future opportunity), the political resistance to this change by the persons adversely affected would be swift, intense, emotional, and, very possibly, successful in the absence of substantial concessions.

Under these circumstances, Congress could be expected either to draw back from the entire proposal or to enact liberal transition rules. This was exactly what happened in the case of unrealized appreciation at death. Earlier attempts to impose a capital gain tax at death were defeated. Finally, carryover of basis at death rules were adopted, but they grandfathered appreciation existing as of January 1, 1977, for which a step-up in basis is allowed.

The nature and extent of transitional rules is at least as much a product of political pressures as of logical principles. The rules themselves are typically intricate and often result in a "double track" system for a number of years, during which not one, but two, sets of rules must be complied with. Obviously, that creates considerable additional complexity for whatever interim period is adopted. Given the nature of capital gains and the fact that individuals of voting age now own assets on which the potential realization of gain could occur any time during the remainder of their lives, the transition periods attending major changes in capital gains rules are likely to be exceptionally long. In the case of the carryover of basis at death rules, for example, transition rules will be a practical problem for another generation.

All of this is not to say that changes in the capital gains rules may not be justified on substantive grounds. Nor is it to deny that there may ultimately be an overall gain in simplicity. The point to be made is that in mapping a program to achieve greater simplicity, the cost/benefit ratio of a change in the capital gains rules must be determined after factoring in the probability that the transitional rules are likely to add considerable complexity for an extended period of time.

MINIMUM TAX AND MAXIMUM TAX

The minimum tax, first enacted in 1969, now imposes a 15 per cent tax on "preferences" in excess of a specified level. The maximum tax,

enacted at the same time, stops the rate bracket progression at 50 per cent for "personal service" income, while "other" income continues to be taxable in brackets going as high as 70 per cent. If the taxpayer has any "preferences," however, each dollar of such preference will cause a dollar of personal service income to be converted into "other" income, which may cause it to be taxed at higher rates.[k] The principal item of "preference" for individuals is the excluded half of capital gains, and as a result of these minimum and maximum tax provisions, the tax on substantial capital gains quickly rises from the nominal maximum rate of 35 per cent (that is, 50 per cent of the gain taxed at the 70 per cent rate) to an effective rate approaching 45 per cent. For taxpayers with very large amounts of earned income, the tax can go as high as 49.125 per cent.

The impetus for the minimum and maximum tax provisions was the political hue and cry in 1969 and thereafter over taxpayers with high incomes who paid little or no tax. The provisions, however, are largely unresponsive to that problem. Of the aggregate preferences for individuals, about 85 per cent concern the excluded half of capital gains. Capital gains, however, are not the kind of item that causes a taxpayer to pay no tax or virtually no tax. On the contrary, capital gains are taxed at half rates, which are more burdensome than the "minimum" of 15 per cent, ostensibly contemplated by the minimum tax.

The minimum tax and the preference provisions of the maximum tax were, in reality, a backdoor means of raising the tax on capital gains under the guise of dealing with another unrelated problem that was, in fact, not dealt with.

[k] The logic for applying the "preference provision" of the maximum tax to capital gains is not apparent. The provision was designed primarily to deal with those preferences that produce tax shelter losses, for example, excessive depreciation deductions. A principal argument for enacting the maximum tax on earned income was that, if tax rates were lower, taxpayers would spend less time and energy looking for tax shelters that would produce artificial losses to be offset against their high-bracket income. A reduction in the rates applicable to earned income, however, would not, without more, achieve that result because tax shelter losses, without some allocation device, would still be taken against the taxpayer's top-bracket income. Absent a special provision, if a 70 per cent bracket taxpayer had $250,000 of earned taxable income and $10,000 of dividend income, the dividend income would remain taxable at 70 per cent and any artificial losses generated by a tax shelter would be deductible first against the $10,000 at 70 per cent rates. The "preference provision" of the maximum tax was designed as a rough allocation device to meet that problem. If $1 of preference transfers $1 from earned income to unearned income, that is, from a 50 per cent bracket to a 70 per cent bracket, the arithmetical result is the same as if the tax shelter loss created by $1 had been deducted at 50 per cent, rather than at 70 per cent. The provision was thus an effective device for insuring that a 50 per cent maximum tax would carry out its intended objective of discouraging tax shelter investments. There was no aim to discourage regular investments, however, and, indeed that would be most undesirable. Nonetheless, when, in the course of the legislative process, capital gains were added to the list of preferences, the provision was applied also to them.

As long as so large a group honestly believes that the present capital gains rules provide a serious inequitable benefit, they will continue to press for higher rates. They will do so by the back door if they cannot persuade Congress and the public to do so directly. In 1973, a Republican Administration proposed a new minimum tax provision targeted directly at the high-income taxpayer who pays no tax, the stated target of the present minimum tax. But the proposal was strongly resisted and ultimately defeated by those who objected to the fact that it would have removed the additional tax on capital gains, except in those limited instances when capital gains were used by high-bracket taxpayers in combination with other items to eliminate all or nearly all their tax liability.

The additional tax on capital gains produced by the minimum tax and the maximum tax is achieved at the price of enormous complexity for the taxpayers involved. Taxpayers with substantial earned income who contemplate capital gains transactions cannot determine the potential tax consequences of those transactions without elaborate computations involving their projected income, their estimated deductions, and a trial computation of their income tax, taking account of the additional schedules relating to the minimum tax, the maximum tax, and the provisions for income averaging. An estimate with any degree of accuracy will take the taxpayer's accountant several hours, at least. If the transaction is consummated, the same exercise must be conducted and the same additional schedules completed when the income tax return is finally prepared.

A great contribution toward simplification of capital gains taxation, second only to eliminating the carryover of basis at death rules, might be achieved if the proponents of the present minimum tax and the preference provisions of the maximum tax would concede that these provisions are primarily additional taxes on capital gains and would urge that these provisions be abolished and replaced with an equivalent, more direct increase in the rates on capital gains. This is unlikely to occur because the proponents of the present system fear that Congress, if it fully understands what is involved, will do the abolishing, but will be unwilling to do the substituting.

Some advocates of greater simplicity suggest that since the maximum rate on capital gains can now go as high as 49+ per cent, it would be a reasonable trade-off to reduce the top individual rates to 50 per cent, tax capital gains at full rates, and eliminate the offending provisions of the maximum and minimum tax. Some of that thinking appears to underlie the September 2, 1977, Treasury proposals. Although the

suggestion sounds cogent when discussed in the aggregate, it founders when applied to individual cases. There would be a roughly even trade-off only for taxpayers in the top 70 per cent bracket. But the great preponderance of capital gains are realized by persons in lower brackets. Nearly half of all capital gains are realized by taxpayers with adjusted gross incomes of less than $30,000.

With the minimum and maximum taxes, we are confronted once again with the fact that very few people are really concerned with complexity, even inordinate complexity, if eliminating it has substantive implications that they oppose. We see that phenomenon most often when simplifying changes would increase the taxpayer's tax. Here, the opposition to simplification springs from abstract notions of equity focused on the taxes of others.

ACCRUAL TAXATION OF UNREALIZED GAINS AND DEFERRAL CHARGES

Even among the sharpest critics of the present system of taxing capital gains, it seems to be widely recognized that the taxation of unrealized gains on an accrual basis cannot be achieved without unacceptable complication.[9] It would be enormously difficult and expensive to value assets each year, and the result would be subject to endless controversy. Further complications would follow from the fact that the taxation of unrealized gains would create major liquidity problems that would doubtless be handled by a new set of rules for exceptions, deferrals, and the like. Also since unrealized appreciation often reflects only temporary fluctuations in value, there would need to be extended rules for carryovers and carrybacks of gains and losses in order to prevent the unfairness that would result from taxes based on interim values that proved ultimately to be wrong. In view of the near consensus on the impracticality of taxing unrealized gains on this basis, it will not be further discussed here as a feasible option.

It cannot be overemphasized, however, that much of the complication in the taxation of capital gains is attributable to both the widespread belief that accrual taxation of unrealized gains is, in theory, the only correct result and the attempts of believers to secure measures to compensate for the failure to tax unrealized gains.

A proposal sometimes advanced to compensate for the failure to tax unrealized appreciation is to impose a "deferral charge" on realized

[9] *See, e.g.*, Wetzler, *Capital Gains and Losses*, in Comprehensive Income Taxation 120 (J. Pechman ed. 1977). Some, most of them theorists, believe it could be done.

gains, that is, an additional tax levied at the time of realization in an amount representing the saving realized by the taxpayer by being permitted to pay the tax later (at the time of realization), rather than sooner (as values currently appreciated).[10]

What are the implications for simplicity of this kind of a deferral charge?

Since much of the present complication follows from the difference between the treatment of realized gains and unrealized appreciation and from the rules required to bridge that difference, a deferral charge, by lessening or reducing the difference, might provide some potential for simplification. In particular, a deferral charge, combined with taxation at ordinary rates, might make it politically practical to remove the limitations on capital losses. The objection to removing these limitations rests on the argument that it is inequitable, as well as costly to the Treasury, to permit taxpayers to realize and deduct their losses while not realizing and thus "deferring" their potential gains. An appropriate deferral charge would respond to these objections. Eliminating the limitations on capital losses would, in turn, pave the way for abolishing the definition of capital assets and the complications that flow from definitional problems.

The difficulty is that a deferral charge would itself create a new set of complications. It would obviously require additional arithmetical steps on individual tax returns. The arithmetic would only be simple if it were imprecise, as a deferral percentage would not be a simple percentage to work with. Unlike indexing of basis for inflation, a deferral percentage would have to be applied to the tax attributable to the gain or, under simplified assumptions, to the gain itself. Breaking out the portion of a taxpayer's tax attributable to a particular gain would, in many cases, be extraordinarily complicated and mechanically very burdensome if a number of transactions were involved. Since the deferral charge is a function of time, it would be necessary to segregate the gain by the time period in which the asset producing it was acquired. That might be relatively easy to do with listed securities (although one would need special rules for stock dividends), but it would be extraordinarily difficult to do with mixed assets, such as a farm. How much of the total gain would be attributable, for example, to a barn built 20 years after a farm was acquired? The difficulty in arriving at honest judgments would be enormous, and the potential for controversy and litigation over those judgments would be overwhelming. A similar problem

10 Such a proposal is set forth in Wetzler, *supra* note 9.

arises in connection with proposals to index gain (as distinguished from indexing basis) for inflation, as discussed below.

Furthermore, any deferral charge formula would need to make assumptions about the taxpayer's marginal tax rates, the interest rate to be used for discount purposes, and the rate at which the gain, once determined for each asset, occurred over the period the asset was held. Certain classes of assets would need to be excluded entirely from the deferral charge (thus creating new definitional problems to replace the definitional problems eliminated by abolishing the capital asset concept) or special and intricate rules would need to be devised for these assets. Suppose, for example, a major industrial facility were constructed over a period of five years, with a purchase price payable at the end of the period. Would a deferral charge be appropriate? Would it run from the day the first dollar was spent on construction, and so forth?

Rules could doubtless be devised that would theoretically respond to all of these questions, using generalized and simplifying assumptions about time periods, interest rates, and the like. Experience suggests, however, that the rules would be initially complex and would grow more so with the passage of time. Furthermore, generalized assumptions, although reasonable, never fit individual facts. For example, if an asset were held for 10 years and sold at a gain, the general rule might assume that the gain occurred ratably over that entire period. But, in fact, it might have occurred almost entirely in the first year or almost entirely in the last year. Or the profit may have been made and lost several times over the 10-year period. Whenever large amounts of money turn on simplified assumptions, an arbitrage potential is created, and complicated tax planning is required in order to arrange transactions to take maximum advantage of the simplified assumptions. For example, each year taxpayers might wish to sell and repurchase assets that had not significantly appreciated so that if appreciation should ultimately occur in large amounts, the deferral charge would reflect only the period during which the appreciation occurred and not the entire time span over which the asset was held.

On balance, a deferral charge, if accompanied by taxation at ordinary rates, would have some potential for simplifying changes, but would appear to create new complications that conceptually would be as great as those now existing and practically would be greater. There appears to be little benefit to trading off old complications that taxpayers have learned to live with for over half a century for new complications that would undoubtedly take them at least a decade to accommodate.

INDEXING FOR INFLATION

Gain, in a *real* economic sense, occurs because a taxpayer is better off than he previously was, and the amount of gain is the amount by which he is "better off." An accounting system based on historical costs does not measure that amount accurately over periods in which the value of money changes. To determine whether a taxpayer has improved his position, his original position and his present position must be restated in comparable dollars.

Suppose, for example, that a taxpayer purchased an asset 10 years ago for $100. He would need to recover more than $100 today in order to maintain equivalent purchasing power. There are a number of indices to measure changes in purchasing power, none of them wholly satisfactory, but all of them preferable to no index whatever. Using the consumer price index, the taxpayer would need to recover about $175 in order to maintain purchasing power equivalent to $100 ten years ago. If he sells the asset for $175, he has no "real" gain or loss, and none should be recognized for tax purposes. If he sells the asset for $180, he is $5 better off, and $5 of gain should be recognized. Note that the $5, that is, the gain, is expressed, and would be taxed, in today's dollars. The adjustment is to the "basis" of the asset, that is, his "original position." There is no logic in adjusting the gain itself.

If there are valid reasons for a contrary analysis, they have not found their way into the serious literature on the subject.

There have, however, been recurrent proposals to adjust capital gains for inflation by varying either the rate of tax or the exclusion factor, both of which operate on gain, rather than on basis. The principal impetus for this approach probably lies in force of habit and in the fact that it is easier for taxpayers and legislators to think in terms of varying the existing 50 per cent exclusion factor than it is to think in terms of devising a totally new system.

There is, however, a further political dimension to these proposals for adjusting gain. For many of our wealthiest individuals, the bulk of their fortune consists of assets on which the appreciation is very large, compared to the basis. This correlation between the very wealthy and low basis-high value assets should surprise no one, as that is exactly how large fortunes are made—by parlaying something relatively small into something very large. It is these taxpayers, and not the average saver, who hire lawyers and lobbyists to work for legislative solutions. But these taxpayers, with little or no basis but very large gains, find little or no benefit in a basis adjustment. They naturally instruct their repre-

sentatives to work for the formula that will produce the largest dollar benefit for them. Similarly, large corporations may have a similar incentive to push for gain adjustments, rather than for basis adjustments. The timber industry is an example, as the gain on timber is taxed as capital gain. The original cost of planting the trees, the basis, is relatively small, and an inflation adjustment operating on the basis, rather than the gain, would produce very little benefit.

The effectiveness with which these groups lobby was illustrated during the executive session deliberations of the Ways and Means Committee in late 1974. The Committee tentatively decided on an inflation adjustment for capital gain. The Treasury Department strongly supported an adjustment to basis, rather than to the gain. But Committee members were subject to strong lobbying pressures and reversed themselves several times, deciding on two separate occasions to apply the adjustment to gain, rather than to basis. In the end, nothing at all was enacted.

If an adjustment applied to the gain had as its only defect that it would overcorrect for inflation in many cases, its enactment would perhaps not be serious. But there are two other defects that are very serious. The first is that a gain adjustment would *completely fail* to correct for inflation in many cases, particularly in cases involving nonwealthy persons who are investing out of current income. The second defect is that a gain adjustment would be vastly more complicated than a correct adjustment applied to basis.

The disadvantage of a gain adjustment to new investors has been dramatically illustrated in the last several years, during which inflation rates have been up and the stock market has been down. An investor who purchased stock two years ago for $100 and sells it today for $112 has no real economic gain, as the Consumer Price Index has increased by about 12 per cent during this period. Applying the increase in the Consumer Price Index to his *basis* would produce an inflation adjusted basis of approximately $112, so that no gain would be realized and no tax would be payable.

If the $12 of nominal *gain* were reduced by the same 12 per cent, however, he would still have a gain of $10.56—all of it illusory. Half would be excluded in computing tax and, if he were in a 70 per cent bracket, he would pay $3.69 of tax. This would not be a $3.69 tax on his income from the sale, for he had no income. It would be a $3.69 confiscation of his original capital investment, even after the 50 per cent exclusion presently provided for.

If, as has sometimes been suggested, an inflation adjustment were

made by increasing the exclusion percentage by, say, 10 per cent for assets held for more than 5 years, 20 per cent for assets held for more than 10 years, 30 per cent for assets held for more than 15 years, and so forth, the taxpayer would be still worse off. Since he held the asset for only two years, there would be no adjustment whatever. The gain would be computed as $12, 50 per cent would be excluded, and a tax of $4.20 would be owing—again a confiscation of capital.

These illustrations make it clear that an adjustment-to-gain approach is fundamentally defective as an inflation-corrective device. Further, they point up an aspect of the current rules that is particularly important to the problem of capital formation. Capital formation is the process of *new* investment. (Existing investments represent capital already formed.) In periods like the present, when the rate of inflation greatly exceeds the rate of growth in real values, those making new investments are faced with the prospect that the present rules, even after the 50 per cent exclusion, may tax away all their real gain and some of their principal. This is a powerful *dis*incentive for savings and investment.

The conceptual defect in all adjustment-to-gain mechanisms is the basic assumption that the percentage of gain that should be excluded as illusory increases as the holding period increases. It is true that the *absolute* amount of inflation and illusory gain increases with time, but it is *not* true that the *proportion* of total gain that is inflation increases with time. Total gain consists of two components: real appreciation and inflation. If real appreciation occurs at the same rate as inflation, the proportion of total appreciation that consists of inflation will remain the same. In this case, it is wrong to exclude a larger percentage of gain as the holding period increases. If, on the other hand, real appreciation occurs at a faster rate than inflation, which was true for many years for listed stocks, the percentage of gain properly excluded should *decline* as holding periods increase.[11]

Thus no system of general indexing will work correctly if applied to gain because it is not the indexed rate of inflation that is properly relevant in this case, but the *ratio* of the rate of inflation to the rate

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11 Professor Roger E. Brinner asserts that the arithmetic of compounding will tend to cause the ratio of real gain to total gain to rise with time, in which case a proper inflation adjustment would call for the exclusion of a decreasing percentage of gain. As an empirical matter, it is probably true that the ratio has risen during long periods in the past. But, as a matter of mathematics, Professor Brinner is unconvincing, for it appears that the formulas he uses would, if solved for inflationary gain, prove that it, too, increases as a proportion of the total gain. Brinner, Capital Formation and Tax Policy (statement before the Subcomm. on Financial Markets, Senate Committee on Finance, Feb. 18, 1976); *see also* R. BRINNER, INFLATION AND THE DEFINITION OF TAXABLE PERSONAL INCOME, INFLATION AND THE INCOME TAX 127 (1976).

of real appreciation; and the latter rate will be different for each individual asset.

It is for this reason that the present 50 per cent exclusion, which operates on gain, fails to work properly as an inflation corrective. The 50 per cent exclusion is an adequate inflation corrective only when inflation accounts for no more than half the nominal gain and an *accurate* inflation corrective only when inflation accounts for exactly half the nominal gain. It corrects for inflation several times over in the case of an investor who bought IBM stock 20 years ago or who has a near-zero basis in a small business that has blossomed, for most of the gain is real gain. The inflationary gain that should be excluded in these cases is only a small percentage of the total gain, yet the exclusion is 50 per cent.

But for the current investor, who is deciding whether to save or to consume—and he is the investor who determines the rate of capital formation—the 50 per cent exclusion is insufficient under current conditions. Over the last few years, virtually *all* of the appreciation in listed stocks is due to inflation, and one would need an exclusion factor of 100 per cent to do the job. It should also be noted that the present 50 per cent exclusion—like all the other mechanisms that operate on gain—does nothing at all for taxpayers who have losses.

The pressing problem is that as inflation and the overstatement of income it creates rise to new highs, the taxes on gains attributable to these years are likely to be taxes not on income but on principal. It is not surprising that investors have become disenchanted with equity markets. Inflation adjustments applied to gain would provide little or no help for new investments, which are the critical determinants of economic vitality. They would serve only to remove from the tax base a portion of the *real* gains of the wealthiest investors.

COMPLEXITY OF INFLATION ADJUSTMENTS

In addition to being wrong, an inflation adjustment applied to gain would entail much more complexity than a basis adjustment. The adjusting percentage under any method is the aggregate amount of inflation, which is a function of time. It is therefore necessary to assign either basis or gain to time periods, and it is infinitely easier to do the former. An adjustment-to-gain mechanism would require valuations and allocations of purchase price in any transaction involving mixed assets, as, for example, in the case of a sale of business assets or a farm. A basis adjustment mechanism is also a complication in such

transactions, to be sure, but the taxpayer can usually go to his books of account, identify the amounts of capital expenditures and the years in which they were made, and apply the corrective percentage in a straightforward manner to the amounts recorded in the books.

In an adjustment-to-gain mechanism, on the other hand, allocations of purchase price would be required, which means that valuation *judgments* would have to be made concerning how much of the total gain was associated with the assets acquired in each different year. For example, if assets acquired over a 20-year period were sold for $5,000,000, producing a total gain of $1,000,000, it would be necessary first to allocate the $5,000,000 among the assets acquired in each of the 20 years. Thus each individual asset would have to be valued, in order to segregate the gain by year, so that an appropriate percentage could, in turn, be applied. Taxpayers have a glimpse of these valuation problems today in connection with asset sales of business and Section 337 (b)(2) liquidations. But in these situations, there are usually only a few key assets or broad classes of assets for which the valuations have a significant dollar consequence, and the only time classification is involved is in determining whether they have been held for more than nine months. With an inflation adjustment to gain, on the other hand, these problems would be infinitely compounded. There would be dollar consequences attendant to virtually every individual item, all of which would have to be segregated by year of acquisition.

One could seek to avoid valuations by prorating gain on some artificial basis, such as allocating it to assets in proportion to their basis. This alone would be a significant mechanical complexity. But more seriously, it would seldom reflect reality and would inevitably lead to complicated tax planning. In order to avoid the artificial rule, taxpayers would segregate assets for sale separately in order to put the gain and the attendant inflation adjustment where they would produce the maximum tax benefit.

In sum, the unprecedented rate of recent inflation has created unprecedented problems in the taxation of capital gain. It can be argued that over past periods in which the rate of inflation rose no faster than the rate of real appreciation, the 50 per cent exclusion served tolerably well as a rough indexing device, although in individual cases it may have radically overcompensated or undercompensated. Clearly, however, it no longer adequately serves this purpose. The distortions created in individual cases have become intolerable. The mismeasurement of income caused by inflation today threatens to turn the tax on capital gains (and the tax on ordinary gains involving depreciation) into

a confiscation of both income and principal for many, if not most, investors. If the present system of taxing gain continues in tandem with the present rate of inflation, they will together threaten the entire savings-investment process and, with it, the economy. In my opinion, no problem of taxation is more critical to our continued economic health.

Any inflation adjustment will add complexity. That is an unfortunate fact. But the problem is too important to permit the desire for simplicity to control. Fortunately, the simplest corrective mechanism, adjustment to basis, is the conceptually correct mechanism and is the only one that will meet the problem. But few taxpayers or legislators—and all too few tax professionals—fully understand either the conceptual implications or the implications for simplification of this mechanism. Particular industries and individual taxpayers peculiarly prone to lobbying would be better off with an adjustment to gain (at the expense of other industries and taxpayers, who would be worse off). We must accordingly be prepared to resist considerable political pressure to adopt an adjustment-to-gain mechanism, which will not do the job and will create more complications to boot.

CONCLUSION

Except in connection with inflation adjustments, I offer no conclusions on the substantive "correctness" or desirability of various proposals for taxing capital gains, and nothing in the preceding discussion is intended to express any such conclusions.

I do conclude that capital gains revisions cannot and will not produce instant simplicity. The case for fundamental revisions must be made on other grounds.

Layers of vexing complication could be stripped away either by outright repeal of the minimum tax, the preference provisions of the maximum tax, and the provisions for carryover of basis at death, or by replacing those provisions with simpler mechanisms. History, however, suggests that, in any such attempt, substantive views would play a larger role than the desire for simplification.

The one area in which the practical need for substantive change is critical is in connection with inflation. As long as the rate of inflation continues to surpass the rate of real growth, the mismeasurement of real income that results will be so great that the present 50 per cent exclusion will not prevent the capital gains tax on future appreciation

from exceeding the real income and from confiscating principal. It is no answer to that gloomy prospect to argue that the 50 per cent exclusion more than compensates for inflation in the case of appreciation that has occurred over the last 15 or 20 years. Overtaxing some taxpayers is not justified by undertaxing others. And, more seriously, it is the outlook for *current* investment and for the taxation of its future profits that will affect the current levels of economic activity and employment in the national economy. We cannot expect satisfactory levels of current investment if we continue a system that threatens to confiscate not only the income from those investments but also a part of the investments themselves.

Unfortunately, any mechanism to correct the mismeasurement of income by inflation will not produce simplification, but rather further complexity. Happily, however, the only adjustment mechanism that will achieve the correction required, the adjustment-to-basis mechanism, also happens to be the simpler mechanism in operation.

G

Simplification for Individual Taxpayers: Ownership of Real Estate

Martin D. Ginsburg

The subject of this paper is the likely impact on individuals of tax simplification measures that may affect the ownership of real property. At the threshold, I define the scope of the topic by excluding the following:

(1) Elimination of the capital asset concept. Treatment of all income as income, and all (or at least all "real") losses as losses would simplify the entire tax law in a major way. Indexing, the adjusting of basis for inflation, particularly in regard to debt-financed property and depreciation rules, could well complicate the tax system in a major way. Pervasive changes of this kind are excluded from consideration.

(2) Individuals are homeowners. Directly or through partnerships, individuals are realty investors. I ascribe that status to the passive partner, although the partnership itself may construct and manage the building it holds for rental income. The homeowner and the individual investor are the concern of this paper. The factory building used in an individual's or partnership's active trade or business is excluded. Also excluded is the individual who invests in realty through a corporation, unless that corporation maintains an election under Subchapter S.

The homeowner and the investor present quite different problems and will be treated separately.

HOMEOWNERS

In the conference agenda earlier circulated, the question was posed, "How might tax simplification be employed to encourage home owner-

* Martin D. Ginsburg is a member of Weil, Gotshal & Manges, New York, New York.
** The author acknowledges the assistance of Martin D. Pollack, who performed the background research in connection with the footnotes to this article.

ship?" In light of the tax benefits currently accorded to homeowners, an extremely simple answer suggests itself: Amend the Internal Revenue Code to provide that any individual who owns a home, whether or not as a principal residence, shall be exempt from federal income tax. With modest regret, I reject this blow for simplification.

Current Law

The favorable tax treatment accorded homeowners is commonly recognized. The net rental value of owner-occupied housing is excluded from income.[1] Home mortgage interest and property taxes are allowed, without limitation, as itemized deductions.[2] In contrast, the home renter is granted no deduction, regardless of whether, in the particular case, it is possible to identify the portion of the lessor's receipts paid out as mortgage interest and property taxes.[3]

Other tax advantages accrue to the homeowner. Gain on the sale of a principal residence is not taxed if the seller timely reinvests in a new principal residence.[4] But proceeds are not traced. The sale may be for cash and the reinvestment mortgage financed.[5] A homeowner over age sixty-four may sell a principal residence, not reinvest, and exclude all or, depending upon the size of the transaction, part of the gain.[6] Use as a principal residence for five years is required.[7] In light of this requirement, the statute's admonition that the elderly taxpayer may sell a principal residence tax-free only once,[8] reflects either a strange notion of simplification or extreme fiscal paranoia. In 1975 we gained, and at the close of 1976 lost, a small complex tax credit for part of the purchase price of a new principal residence.[9] In 1972 we gained confirmation of, and have not lost, a special advantage for the well-to-do homeowner: Apparently, without regard to amount,

1 *See* A. Kragen & J. McNulty, Federal Income Taxation 66 n.2 (1970). *See generally* Marsh, *The Taxation of Imputed Income*, 58 Political Sci. Q. 514 (1943).

2 I.R.C. §§ 62, 63 (f), 163, 164.

3 *Id.* § 262.

4 *Id.* § 1034.

5 Although the statute requires reinvestment before granting nonrecognition, reinvestment is defined in terms of "the taxpayer's *cost* of purchasing the new residence." *Id.* § 1034(a) (emphasis added). The term *cost* includes the face amount of any liabilities of the taxpayer that are part of the consideration for the purchase. Treas. Reg. § 1.1034-1 (c)(4)(i).

6 I.R.C. § 121.

7 *Id.* § 121(a)(2).

8 *Id.* § 121(b)(2).

9 *Id.* § 44, added by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 208(a), 89 Stat. 26, 32 (1975), *amended to cease applicability*, Emergency Compensation and Special Unemployment Assistance Act of 1975, Pub. L. No. 94-45, § 401(a), 89 Stat. 236, 243-44 (1975).

no part of the home mortgage interest deduction is in jeopardy when the taxpayer owns tax-exempt bonds.[10]

Mortgage Interest and Property Taxes

The revenue loss generated by these tax expenditures has been variously estimated. For the fiscal year 1976, based on the tax laws in effect on January 1, 1975, Break and Pechman calculated the home mortgage interest tax expenditure at $6.5 billion and the owner-occupied property tax deduction advantage at $5.27 billion.[11] For the same fiscal year, the Senate Committee on the Budget estimated the mortgage interest advantage at $4.545 billion and the property tax advantage at $3.69 billion. For fiscal 1977 and 1978, the Subcommittee on the City of the House Committee on Banking, Finance, and Urban Affairs recently projected the interest/property tax homeowner subsidy at $9.57 billion and $10.2 billion, respectively.[12] Some years earlier, working from 1968 Statistics of Income, Paul Dodyk developed an instructive analysis of homeownership tax subsidization, by taking into account deduction of mortgage interest and property taxes and exclusion of rental value, and presented the resultant advantage by adjusted gross income class.[13]

The following data, derived from the Senate Budget Committee's tax expenditures compendium, published in the spring of 1976, is also instructive.

Adjusted Gross Income Class	Per Cent of Taxable Returns	Property Taxes	Mortgage Interest
0 to $7,000	29.7%	2.2%	1.3%
$7,000 to $15,000	40.9%	19.8%	23.6%
$15,000 to $50,000	28.2%	62.7%	65.9%
$50,000 and over	1.2%	15.3%	9.1%

Home mortgage interest and property taxes are itemized deductions.[14] After the Tax Reform Act of 1976, only one individual tax return in

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10 Rev. Proc. 72-18, 1972-1 C.B. 740.

11 G. Break & J. Pechman, Federal Tax Reform: The Impossible Dream? 15 (1975).

12 Subcommittee on the City of the House Committee on Banking, Finance, and Urban Affairs, Report on Federal Tax Policy and Urban Development, 95th Cong., 1st Sess. 2, 4 (1977).

13 Dodyk, *The Tax Reform Act of 1969 and the Poor,* 71 Colum. L. Rev. 758, 784 (1971). Dodyk's tabular analysis is reproduced on page 258; the 1977 tabulation of the Subcommittee on the City follows on page 259.

14 Note 2 *supra.*

Adjusted Gross Income Class	Real Estate Taxes Deducted (Thousands)	Revenue Lost (Thousands)	Mortgage Interest Deducted (Thousands)	Revenue Lost (Thousands)	Imputed Value of Owner-Occupied Housing (Thousands)	Revenue Lost (Thousands)	Total Housing Assistance (Thousands)	Total Housing Assistance Per Return (Thousands)
$1,000–$2,000	$ 19,582	$ 2,741	$ 5,197	$ 728	$ 22,519	$ 3,152	$ 6,621	$ .88
$2,000–$3,000	69,841	9,778	27,038	4,185	80,318	11,244	25,207	$ 4.27
$3,000–$4,000	137,286	20,693	66,642	9,996	157,872	23,794	54,483	$ 9.80
$4,000–$5,000	219,864	35,178	153,969	25,635	252,670	40,446	101,259	$ 19.18
$5,000–$6,000	282,554	48,034	272,924	46,397	324,875	55,236	149,667	$ 29.93
$6,000–$7,000	338,843	57,603	434,000	73,780	389,620	66,240	197,623	$ 39.72
$7,000–$8,000	478,973	91,004	571,606	108,605	549,735	104,650	304,259	$ 64.73
$8,000–$9,000	591,818	112,445	768,368	145,990	680,570	129,160	387,595	$ 82.52
$9,000–$10,000	628,701	119,453	812,626	154,399	781,405	137,310	411,162	$ 102.79
$10,000–$15,000	2,831,275	662,880	3,519,578	774,307	3,255,650	762,220	2,199,407	$ 183.28
$15,000–$20,000	1,353,775	338,444	1,494,237	373,559	1,565,950	389,160	1,101,163	$ 300.86
$20,000–$25,000	558,575	164,801	565,001	158,200	676,765	189,520	512,521	$ 430.97
$25,000–$30,000	307,122	98,279	275,770	88,146	333,165	112,010	298,435	$ 573.83
$30,000–$50,000	550,492	214,692	344,496	134,353	632,960	246,890	595,935	$ 827.68
$50,000–$100,000	331,910	175,912	126,463	67,025	381,685	202,281	445,218	$1,484.06
$100,000–$200,000	107,930	66,907	21,037	13,043	123,985	76,935	156,885	$2,490.02
Over $200,000	65,877	46,835	5,930	4,091	75,750	53,845	104,771	$7,286.00
Total	$8,874,418	$2,265,679	$9,464,882	$2,182,439	$10,285,494	$2,604,093	$7,052,211	

93. The amounts shown in Table II for real estate taxes and mortgage interest deducted are taken from Int. Rev. Serv., 1968 Statistics of Income 68, 71. The amount of the exclusion shown for the imputed rental value of owner-occupied housing was determined as described in note 86 *supra*. The amounts shown are for taxable returns only, the data being insufficient to distribute deductions appearing on nontaxable returns among the adjusted gross income classes. The figures shown accordingly exclude $427,694,000 of real property taxes and $471,136,000 of mortgage interest deducted on nontaxable returns. The amounts of excluded net rental value of owner-occupied housing have been distributed among adjusted gross income classes in the same proportion as real estate tax deductions. The revenue loss for real estate tax deductions, mortgage interest deductions, and exclusion of the imputed rental value of owner-occupied housing for each adjusted gross income class has been computed by calculating the average taxable income per return for each such class and multiplying the rate of tax applicable to such taxable income by the aggregate amount of deduction or exclusion shown for that class. The figures derived by such computations are significantly higher than those shown in the 1968 Sec'y of Treas. Ann. Rep. 340 and in Table I. The distribution of housing benefits among adjusted gross income classes is distorted by the above-mentioned exclusion of nontaxable returns and by disregard of the effect of the standard deduction. If one accepts the view that some portion of the revenue lost by virtue of the standard deduction is properly attributable to the real estate tax and mortgage interest deductions in lieu of which, *inter alia*, the standard deduction is taken, some adjustment of Table III would be required, for inclusion of some part of the standard deduction would doubtless increase the relative amounts of housing aid accruing to the lower and the lower-middle adjusted gross income classes.

1977 Homeowner tax incentives[1] *(1977 law and income levels)*

AGI (thousands)	Number of total returns	Number of homeowners[2]	Number of returns with homeowner deductions[1]	Average homeowner deductions[1]	Average tax saving from homeowner deductions[1]	Total tax saving on revenue loss (millions)
0 to $5	24,727,641	7,265,000	134,379	$838	$78	$10
$5 to $10	19,300,082	9,000,000	940,171	878	123	116
$10 to $15	15,145,227	9,820,000	2,471,680	1,023	193	477
$15 to $20	12,022,433	8,150,000	4,079,777	1,075	247	1,008
$20 to $30	11,891,768		6,927,354	1,518	419	2,903
$30 to $50	4,433,064	12,634,000	3,392,576	2,228	828	2,809
$50 to $100	1,182,244		984,410	3,185	1,580	1,555
$100 plus	297,941		263,514	4,719	2,622	691
Totals	89,000,400	46,867,000	19,193,861	1,579	499	9,569

[1] Deductions for home mortgage interest payments and property taxes.

[2] Bureau of the Census, Annual Housing Survey: 1975, series II–150–75C, pt. C, p. 1 (March 1977). This column shows homeowners in 1975 at 1975 income levels and this is not exactly comparable to the 1977 data used in the rest of the table.

Note.—Details may not add to totals because of rounding.

Source: Staff of the Joint Committee on Taxation and the Congressional Budget Office.

four has reflected itemized deductions.[15] A continuing and salutary tax legislative objective is to further reduce the percentage of individual taxpayers who itemize. Although the rental value exclusion may be viewed as aiding nearly all taxpayer homeowners, the interest and tax deductions aid a more affluent and contracting percentage of taxpayers.

Section 163(d).[16] The present distinction between personal interest expense and investment interest expense deserves attention. In general, Section 163(d) now limits the current deduction of investment interest to the sum of $10,000, plus net investment income (nonbusiness interest; dividends; rents; royalties; short-term capital gain; and certain recapture income, less specified related expenses).[17] Excess investment interest expense is carried forward.[18] Neither personal interest expense nor trade or business interest expense is subject to any analogous deduction limitation.[19] The proper characterization of an interest expenditure is not always intuitively obvious. The special rule in Section 163(d)(4)(A) for property subject to a net lease reacts in part to this reality.

Proposals for Change. Less than clear is the conceptual justification for an unlimited personal interest expense deduction in general and an unlimited homeowner expense deduction (mortgage interest and property taxes) in particular. Break and Pechman, among others, argue forcefully that the deduction is inappropriate as long as imputed rental value is excluded.[20] Deductions of this sort have been part of the tax law since the beginning of time[21] and, as Henry Mansfield has succinctly noted, longevity seems to be the primary justification advanced in their behalf.

A comprehensive income tax base is a superficially attractive notion. The problems, as well as the possibilities, were well ventilated in the past decade's *Harvard Law Review* debate among Bittker, Galvin, Musgrave, and Pechman.

> [Bittker]: The exclusion from gross income, as presently defined, of the net rental value of owner-occupied residences has been a com-

[15] S. Rep. No. 95-66, 95th Cong., 1st Sess. 50 (1977), *reprinted in* [1977] U.S. Code Cong. & Ad. News 751, 796.

[16] Unless otherwise indicated, section references are to the Internal Revenue Code of 1954, as amended.

[17] I.R.C. § 163(d)(1), (3).

[18] *Id.* § 163(d)(2).

[19] *Id.* §§ 163(a), 163(d)(1), 163(d)(3)(D).

[20] G. Break & J. Pechman, Federal Tax Reform: The Impossible Dream? 23 (1975).

[21] *See* Act of August 27, 1894, Pub. L. No. 53-227, ch. 349, § 28, 28 Stat. 509 (1894); Act of July 1, 1862, Pub. L. No. 37-97, ch. 119, § 91, 12 Stat. 432 (1862).

mon target of commentators, and some have also criticized the failure to tax imputed income from other assets, for example, the net rental value of household furnishings and the value of bank services provided in lieu of interest on idle balances in checking accounts. Acknowledging that it would not be easy to value these economic advantages or to enforce compliance, most advocates of a [comprehensive tax base] would evidently be satisfied with taxing the imputed rent of owner-occupied residences and willing to exempt imputed interest from other assets.[22]

[Musgrave]: Professor Bittker criticizes proponents of the comprehensive tax base for demanding inclusion of imputed rent in taxable income, without extending the same principle to imputed income from other assets. The answer again is that in principle all imputed income (including even income from cash holding) should be taxed, but that it is not a feasible procedure. Taxation of imputed rent, on the other hand, is feasible. The inequity between owners and renters, which results from the present practice of deducting mortgage interest while not taxing imputed rent is unfair, especially at the lower end of the income scale, and could be improved even by a rough approximation to imputed rent.[23]

Because of the increase in the "standard deduction," [24] which now encompasses about 75 per cent of all individual income tax returns [25] and is likely to cover a greater percentage near term, Professor Musgrave's 1967 concentration on the lower end of the income scale no longer persuades. Put simply, since 1969 "successive increases in the standard deduction have sharply eroded the value of home ownership tax deductions for those with low and moderate incomes." [26] "Rough approximation" is not the best base on which to build a self-assessment system. Evaluation tends to follow advantage, and the audit burden is too heavy. Tax simplification will not be advanced by the taxation of imputed rental income.

Nor would we be well advised to reverse direction and allow an

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[22] Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform,* 80 HARV. L. REV. 925, 947-50 (1967).

[23] Musgrave, *In Defense of an Income Concept,* 81 HARV. L. REV. 44, 56 (1967). *See also* Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR,* 81 HARV. L. REV. 1016 (1968); Pechman, *Comprehensive Income Taxation: A Comment,* 81 HARV. L. REV. 63 (1967).

[24] The Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 102(a), 91 Stat. 126, 135 1977), changed the statutory terminology so that "standard deduction" has been replaced by "zero bracket amount." I.R.C. § 63. The concept remains the same however. *See* S. Rep. No. 95-66, 95th Cong., 1st Sess. 50-53 (1977), *reprinted in* 1977 U.S. CODE CONG. & AD. NEWS 751, 797-99. The more familiar "standard deduction" terminology will be used throughout this paper.

[25] *See* note 15, *supra.*

[26] Note 12, *supra,* at 7.

itemized deduction, limited or unlimited, for home rental payments. Almost certainly, a significant number of taxpayers would shift from taking the standard deduction to itemizing deductions, hardly a desirable objective. To balance a historic anomaly, we will have embraced a greater one. All more affluent taxpayers will deduct major personal living expenses; a large percentage of less affluent taxpayers, still on the standard deduction, will not.

If change is to focus anywhere, it must focus on the mortgage interest and property tax deductions. Choices of change include eliminating the deduction, a deduction floor,[27] a deduction ceiling,[28] and converting from deduction to credit.[29] For reasons I find convincing, Harry Mansfield, in his paper to this conference, has rejected the floor notion and denigrated the credit.[30]

"Eliminating the deductibility of state and local property taxes on owner-occupied homes . . . might well induce those governments to gradually shift their tax systems to greater use of (deductible) sales and income taxes. . . ."[31] Property tax deductibility reasonably may be viewed as a form of federal revenue sharing, and the shift predicted by Break and Pechman is consistent with that view. Property taxes are locally important in every state. It would appear unwise to upset the present local exaction/federal deduction balance without first ascertaining in a more reliable way the time and nature of reaction and the enthusiasm with which we may greet the final outcome.

Complete elimination of, or placing a separate low ceiling on, the deduction for home mortgage interest and other personal expenditures seems ill advised as long as some substantial amount of deduction of investment interest is allowed. Middle-income taxpayers are significantly disadvantaged. Wealthier individuals are urged to run today's road in reverse. Currently, advantage accrues to a large home mortgage and to circumscribed borrowing for investment. In an opposite world, investments are liquidated, the home mortgage is paid, and new investments are debt financed through personal borrowing power. The rich can release personal assets from encumbrance and borrow substantial

[27] *Compare* I.R.C. § 213(a)(1).

[28] *Compare id.* § 217(b)(3).

[29] *Compare* Int. Rev. Code of 1954, ch. 1, § 214 (as in effect prior to its repeal by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 504, 90 Stat. 1520 (1976), *with* I.R.C. § 44A.

[30] The Subcommittee on the City recently quoted a Joint Committee Staff/Congressional Budget Office estimate that converting homeowner deductions to credits at a 25 per cent rate ($4 deduction equals $1 of credit) would cost the Treasury in excess of $2 billion annually. SUBCOMMITTEE ON THE CITY OF THE HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS, REPORT ON FEDERAL TAX POLICY AND URBAN DEVELOPMENT, 95th Cong., 1st Sess. 12 (1977).

[31] G. BREAK & J PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? 20 (1975).

moneys; upper-middle-income taxpayers and those below them on the economic ladder ordinarily cannot do so.

Section 163(d), the investment interest deduction limitation, hardly qualifies as a tax simplification measure. But there is every reason to believe it will remain with us. If we accept this condition, a balance among competing considerations might be struck by expanding the statute to encompass personal interest expense as well as investment interest expense. Whether Section 163(d) might be further expanded to encompass property taxes (imposed on tangible investment assets and personal assets) merits further study.

Regardless of whether expanded Section 163(d) covers interest only or is extended to property tax as well, the statute's $10,000 "in all events" deduction permission [32] deserves fresh examination. Conceivably, that floor amount should be raised fairly substantially if property taxes are added to the catalog.

Amending Section 163(d) to encompass personal interest expense and, perhaps, property taxes will redress, in part, the present imbalance between homeowners and home renters. Assume O, a homeowner, has no investment income and pays $2,000 in property taxes, $5,000 in home mortgage interest, $4,000 in other personal interest expense, and $14,000 in investment interest. Assume R, a tenant of equivalent premises, has investment income of $5,000 and pays $12,000 in nondeductible rent, $4,000 in personal interest expense, and $14,000 in investment interest expense. Both O and R are in the 50 per cent tax bracket. If the Section 163(d) minimum deduction permission is set at $15,000 and property tax, as well as personal and investment interest are covered, O will deduct currently only $15,000 of his total $25,000 expenditure. R, having no homeowner expenses to absorb the deduction allowance, will deduct currently his entire $18,000 interest expense. Net of $5,000 investment income, R's deduction is $13,000. Net of tax benefit, R's current outlay totals $18,5000. O's current outlay is $17,500. Under existing law, R's current outlay also would be $18,500, but O's net cost would be only $14,500. Under present law, R outpays O by $4,000. Under amended law, it would be only $1,000, a 75 per cent reduction in differential treatment.

Assuming, once again, that Section 163(d) will remain part of the tax law, expanding its coverage to include personal interest expense (and, perhaps, property taxes imposed on tangible investment and personal assets) can be viewed as a simplification measure. Determination of purpose, whether personal or investment, becames irrelevant. Stan-

32 I.R.C. § 163(d)(1)(A).

dard deduction taxpayers and itemizers whose expenditures are within the minimum deduction permission would not be adversely affected by the change. They are the vast bulk of individual taxpayers.[33] The burden would fall on the relatively small group of higher income taxpayers who are currently deducting substantial amounts of interest denominated "personal," such as the wealthy mansion owner or, indeed, the yacht owner. For them, as for other itemizers, any added reporting burden is light and becomes a matter of simple addition and subtraction. For the Internal Revenue Service, the audit burden of distinguishing personal from investment interest is simplified out of existence.

In sum, with an eye to both tax equity and simplification, alternative approaches may be proposed. One alternative is to expand Section 163(d). The other option is to retain, without change, the present unlimited deductibility of home mortgage and other personal interest and property taxes. None of the other recommendations for reform appears acceptable.

Sale of Principal Residence

Section 1034, allowing tax-free reinvestment when a principal residence is sold, should be retained. The seller's ability to hold cash proceeds and "reinvest" through debt financing[34] should not be a focus of change in the governing law. The seller can too easily reinvest cash and, later, borrow cash against the security of the property.

If neither Section 121 (sale of a principal residence by an elderly individual) nor Section 1034 is on point, gain on the sale of a residence is taxable.[35] But loss on the sale of a residence generates no allowable deduction.[36] Because of uncertainty concerning whether prior expenditures were repairs or capital improvements, at times the seller may not know if he or she has gain or loss, and many times the seller may acknowledge gain but not know the amount. When sale price does not exceed $35,000 and the seller is at least age sixty-five, Section 121 obviates the problem. When the sale price is greater, Section 121 blunts the impact, but does not cure the problem.[37]

Section 121 seems to me to proceed in the right direction, but it is too circumscribed and complex. A more generous and pervasive permission deserves consideration.

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33 *See* the discussion in the text accompanying note 25, *supra*.

34 *See* note 5, *supra*, and accompanying text.

35 I.R.C. § 1001(c).

36 *Id.* § 165(c).

37 *Id.* § 121(b)(1).

On the sale of a principal residence that is occupied for some specified, reasonable period by the taxpayer or the taxpayer's decedent, a respectable exclusion should be available. Proceeding from present Section 121, one approach would be to eliminate the age requirement and raise the current $35,000 Plimsoll line to a selling price of, say, $75,000.[38] A quite different approach would look for inspiration to the cumulative lifetime exemption from gift tax that was accorded under pre-1977 law.[39]

Under this approach, neither the taxpayer's age nor the selling price of the home is relevant. Marital status, however, is very relevant. Assume the selected exclusion is $20,000 per individual ($40,000 per marital unit). If Mr. A owns his first home, has occupied it as a principal residence for the statutorily prescribed period, and sells it at a $30,000 gain that is not reinvested, he will exclude $20,000 and pay tax on $10,000. If Mr. A is married and his co-occupant wife is not an owner, they nonetheless may elect to split the gain so that $15,000 goes to each. Each will exclude that $15,000, and will retain a $5,000 unused cumulative exemption. The same permission should apply to Mr. A's estate and surviving spouse if, after his death, the home is sold within a statutorily prescribed reasonable time.

Whatever route is taken, attention should be paid to the repair/capital improvement dichotomy.[40] A draconian solution may be in order. For example, every expenditure is a repair (not added to basis) unless the aggregate of demonstrable expenditures during a period of, say, 24 consecutive months exceeds the greater of $3,000 or 10 per cent of the original cost of the property. In that event, provable expenditures during the "improvement" term are capital. Although a formulation of this kind inevitably encourages a bunching of repairs or a bunching of repairs together with a true capital improvement, the minimum expenditure test should weed out a host of small or nuisance cases. The notch problem, that $2 of additional expenditure may convert $2,999 of repair costs to capital improvements, is apparent;

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38 If I.R.C. § 1023, the carryover basis at death provision, remains in the law, it should be amended to provide that the basis of the decedent's principal residence in the hands of the successor shall not be less than the lower of fair market value or $75,000.

39 The $30,000 lifetime gift tax exemption exempted the donor from gift tax on his or her first $30,000 of otherwise taxable gifts. *See* Int. Rev. Code of 1954, ch. 1, § 2521 (as in effect before its repeal by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(b)(3), 90 Stat. 1570, 1849 (1976)). When combined with the gift-splitting privilege, I.R.C. § 2513, a married donor was relieved of the burden of paying gift tax on as much as his or her first $60,000 of otherwise taxable gifts. For gifts made after December 31, 1976, the exemption has been replaced with a credit. I.R.C. § 2505. *See generally* 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT, AND ESTATE TAXATION § 51.12 (1977).

40 *Compare* Treas. Reg. § 1.167(a)-11(d)(2).

however, the conduct encouraged, upkeep, as well as improvement of the home, is salutary. Additionally, if the Section 121 sale price line or the cumulative exemption is set sufficiently high, characterization as repair or capital improvement will be of limited practical significance to most homeowners. Under present law, the characterization problem complicates the tax reporting life of too many taxpayers at all economic levels. An articulated statutory test should qualify as a simplification measure.

The Rented Room

A considerable number of homeowners, particularly elderly homeowners, rent rooms during all or part of the year to students, teachers, salespersons, and others. In general, these homeowners receive circumscribed income from other sources, and the modest rental receipts are important to them. They are heavily burdened by the complexity of current tax law.

Deductions, including allocable interest, property taxes, and depreciation, attributable to property held for the production of rents are, under Section 62(5), taken "above the line" in reaching adjusted gross income. Thus the room-leasing standard deduction taxpayer is allowed to deduct rent-related expenditures. Unfortunately, he or she must first calculate them and reflect them on the personal income tax return. The taxpayer who leases a room in his or her home is not, ordinarily, a sophisticated taxpayer. The reporting burden is oppressive.

The April 1973 Treasury publication, *Proposals for Tax Change,* in its "reverse legislation" recomendation, adverted specifically to the problems of the elderly taxpayer who derives modest rental income. However salutary in other respects, the 1973 *Proposals* did not react adequately to the reporting problems of the room lessor.[41] Simplification requires reexamination at the root.

When property is leased or licensed by an individual who is not conducting a trade or business, why does it necessarily follow that related expenses are to be taken "above the line"? Expenses incurred in producing other investment income, for example dividends and interest, are "below the line" itemized deductions. At the moment, the Section 62(5) special treatment of rent- and royalty-related expendi-

[41] *See* Department of the Treasury, Proposals for Tax Change 33 (1973), in which a draft simplified individual income tax return Form 1040-S is set out. Line 5 refers to gross rents "less expenses," and the accompanying instruction refers to "depreciation and other expenses." This, of course, is not a solution to the problem. It is simply a restatement.

tures appears to serve a major function that a rational legislature hardly could have intended. A bailment of property (including intangible property) produces fees that are "in the nature of" rent to the bailor. If the bailor acquired the property through debt financing, his interest expense is or surely will be claimed to be "attributable to property held for the production of rents."[42] To the high-income taxpayer, "above the line" treatment is most advantageous when, for example, he is in minimum tax jeopardy (or losing the maximum tax benefit) under the excess itemized deductions tax preference rule of Section 57(a)(1) and (b).[43] There seems to be little reason why the tax law should encourage a bailment of liquid assets (to a bailee that will borrow on the security of the assets) when, in normal circumstances, the taxpayer simply would have loaned money and earned interest income.

If there is no strong policy justification for retaining Section 62(5), it ought to be repealed. Rent- and royalty-related expenditures, not connected with a trade or business, should be itemized deductions. For those on the standard deduction, and focusing specifically on the low-income, often elderly, room lessor, I would propose a tailored exclusion for the first $X of rental income derived from the residential leasing part of the property then occupied by the taxpayer as his or her principal residence. The dollar figure might be set to approximate the net tax revenue that leasing arrangements of this kind now yield.

INVESTORS

Homeowners to the side, the prototypical individual real estate investment is through a limited partnership. Investment advantage is measured in cash flow, from rental income in excess of expenditures, from excess deductions offset against other income, and, in some cases, from both. Leverage, the use of money borrowed, ordinarily without personal recourse against the investor, occupies a foreground position in the realty investment picture.[44]

There are three stages to a healthy real estate investment: initial

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[42] To my knowledge, the Internal Revenue Service has issued at least one private letter ruling directly confirming that bailment fees are rental income and at least inferentially confirming that Section 62 (5) is applicable to the bailor's expenses of carrying the bailment property. In the ruling case, the property involved was securities.

[43] This is not to say, of course, that it is always advantageous to a taxpayer for his deductions to be taken above the line. *See, e.g.,* I.R.C. § 170 (b) (1) (ceiling on charitable deduction directly related to adjusted gross income).

[44] *See generally* Rabinowitz, *Real Estate and the Federal Income Tax: The Status of the Law Today,* 32 N.Y.U. Inst. on Fed. Tax. 1593 (1974).

purchase or period of construction, holding for rent, and ultimate disposition. In a failing investment, faced with an unplanned and highly undesirable early disposition to the foreclosing mortgagee, investors may seek to vary the pattern. Property-holding arrangements will be modified to avoid foreclosure but not because the realty investment is inherently sound or because the investor's personal assets are exposed to the mortgagee. Neither reason is true. Rather, early termination is to be avoided because the investor is exposed to the fisc.[45] Current tax law encourages the leveraged real estate investment and discourages taking leave of it.

The Realty Tax Shelter

At its fullest, a tax shelter combines concepts of deferral, conversion, and leverage. Deferral, deductions in advance of related income, is the essential concept. Conversion, treatment of the later income as long-term capital gain, remains valuable, despite rate changes and the advent of minimum and maximum taxes. Leverage supplies a multiplier effect; nonrecourse borrowing affords the advantage unencumbered by offsetting personal risk. Because it furnishes all these benefits, real estate has long qualified as a premier tax shelter investment. Although tax legislation of the past decade has circumscribed the realty investment advantage in some respects[46] by impacting more heavily on other types of investment,[47] real estate has been made relatively more attractive as a tax shelter.

In the June 1975 panel presentation on tax simplification to the House Ways and Means Committee, Sheldon Cohen identified as a single generator of complexity the apparent congressional belief that, for every economic or social problem, the Internal Revenue Code can be amended to provide a solution.[48] No better example can be found than the subsidization, through the taxing system, of low- and moderate-income rental housing. The Congressional Budget Office concluded:

> The primary function of real estate tax shelters is to provide developers and builders of rental property with part of the money

[45] On a disposition of property subject to a mortgage, the amount realized for purposes of computing gain includes the unpaid balance of the mortgage. Crane v. Commissioner, 331 U.S. 1 (1947). *See generally*, Rabinowitz & Berenson, *The Failing Real Estate Investment and the Federal Income Tax*, 34 N.Y.U. Inst. on Fed. Tax. 357 (1976); Handler, *Tax Consequences of Mortgage Foreclosures and Transfers of Real Property to the Mortgagee*, 31 Tax L. Rev. 193 (1976).

[46] *See, e.g.*, I.R.C. §§ 167(j), 189, 1250.

[47] *See, e.g.*, *id.* §§ 465, 704(d).

[48] *Panel Discussions on Simplifying and Restricting the Tax Law Before the House Committee on Ways and Means*, 94th Cong., 1st Sess. 132 (June 24, 1975) (statement of Sheldon Cohen).

> they need "up front" to finance new building construction. Tax shelters provide a 10- to 20-year stream of tax savings which the builder/developer can sell to wealthy outside investors. The money they pay him is used, along with a mortgage loan, to finance construction of the building. In effect, therefore, real estate tax shelters are simply a device to provide a government subsidy for building construction.[49]

This use of the tax system raises concerns now well recognized. The tax subsidy is cost inefficient in two respects:

> Only about half of what the tax shelter subsidy costs the government in lost revenue, however, ever reaches builders and developers. The remainder goes in the form of payments to the outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the tax shelter package.
>
> In addition, less than two-thirds of the estimated $1.3 billion a year the government loses in tax revenue from real estate tax shelters is used to subsidize construction of rental housing. The remainder subsidizes the construction of office buildings, shopping centers, and other commercial buildings. And of the total subsidy, only about 11 per cent is used to assist low- and moderate-income rental housing construction. The rest of the rental housing share provides subsidies for middle- and upper-income rental housing.[50]

Whatever the merits of the decision to subsidize low-income housing through the tax system, deferral, conversion, and leverage have accrued to a host of taxpayers who were not intended beneficiaries. Bifurcated legislative responses were formulated to distinguish between the investor in personalty and the investor in realty; the investor in commercial structures and the investor in housing; the investor in high-income rental housing and the investor in low-income housing projects; conversion and the risks of early recapture to the mass of doctors and and the investor who offsets too high a percentage of income from the less aggressive investor, in order to distinguish the "bad" investor from the "good" investor. It is hardly surprising that the one clear product of this legislative effort is extraordinary complexity in the tax law.

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[49] CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES xiv (1977).

[50] *Id.* More recently, the SUBCOMMITTEE ON THE CITY OF THE HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS, in its REPORT ON FEDERAL TAX POLICY AND URBAN DEVELOPMENT 14-16 (1977), asserted that the tax shelter subsidy is additionally defective, since it makes new construction substantially more advantageous economically than repair and rehabilitation of existing housing and fosters suburban development at the expense of the cities.

Current Law

Organized under a state statute corresponding to the Uniform Limited Partnership Act and with due regard to the Service's roadmap pronouncements on corporate general partners and the like, a limited partnership for tax purposes will be treated as a partnership and not as an association taxable as a corporation.[51] It thus serves as the vehicle to democratize the tax shelter, by bringing the benefits of deferral and conversion and the risks of early recapture to the mass of doctors and dentists.

The Tax Reform Act of 1976 withdrew from partnership investors much of the advantage of nonrecourse borrowing.[52] As a key exception, the limitation does not apply to any partnership the principal activity of which is investing in real property.[53] Although this exception does not extend to mineral property, it does apply to all structures, whether commercial or residential and whether intended for high- or low-income residents.[54]

The individual investor, operating directly or through a partnership or Subchapter S corporation, is restricted in deducting real property construction period interest and taxes.[55] New Section 189 allows current deduction in part and requires capitalization and amortization of the balance. Before Section 189, the investor enjoyed immediate deduction in full, well in advance of first rental income receipts.[56] The new provision is complex in many respects, but it is clear in exempting low-income housing expenses paid in taxable years beginning prior to 1982.[57] Why the new capitalization provision applies to real property and not to personal property or why it applies to individuals and not to corporations that develop real property (other than Subchapter S corporations and personal holding companies) is not clear.

The depreciation rules are extraordinarily complicated. Section 167 now appears to qualify as the Code's longest income tax provision.

[51] *See* Zuchman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976), appeal docketed, No. 5267-73 (9th Cir. Sept. 14, 1976); Treas. Reg. §§ 301.7701-2, 301.7701-3(b)(1); Rev. Proc. 74-17, 1974-1 C.B. 438; Rev. Proc. 72-13, 1972-1 C.B. 735. *But see* President's Tax Message, as sent to Congress on January 21, 1978, Fact Sheet 16 (suggesting that limited partnerships with more than 15 limited partners, other than those primarily engaged in residential real estate, be treated as a corporation) [hereinafter cited as President's Tax Message].

[52] I.R.C. §§ 465, 704(d).

[53] *Id.* § 704(d).

[54] *Id.*

[55] *Id.* § 189.

[56] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 25 (1976).

[57] I.R.C. § 189(b).

The 200 per cent declining balance (or the sum of the years' digits) method is allowed for new rental housing, regardless of whether it is for low-income residents.[58] For new commercial buildings, 150 per cent declining balance depreciation is available.[59] Used residential realty having at least a 20-year life can enjoy 125 per cent declining balance depreciation.[60] Used nonresidential property is limited to straight-line depreciation.[61] Under the straight-line method, only the excess of cost above estimated salvage value is subject to depreciation.[62] Under the declining balance method, depreciation is based on unrecovered cost; salvage value limits the aggregate depreciation deductions that may be taken, but is not otherwise a factor in the depreciation calculus.[63] Since virtually no class lives for buildings have been prescribed by the Treasury to date, under Section 167(m) and Section 5 of Public Law Number 93-625 (1975), the ADR system[64] is not in point; the taxpayer may estimate useful life under a "facts and circumstances" test.[65] The Service's published guideline lives[66] are instructive but, at the taxpayer's election,[67] not determinative.[68]

This hodgepodge of depreciation rules is unsatisfactory for reasons beyond that of its complexity. In estimating building life and salvage value, not surprisingly, taxpayers reach advantageous conclusions. Useful life is announced to be shorter than, and salvage value less than, a dispassionate analyst might determine. The accelerated depreciation methods sanctioned by statute[69] simply do not accord, in most cases, with the true economic depreciation of structures.[70] The result may be justified as an intended tax subsidy for the investor in low-income rental housing, but it cannot be justified as a reflection of economic reality or as helping to meet the nation's need for additional luxury apartment buildings.

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58 *Id.* §§ 167(b), 167(j)(1), 167(j)(2).

59 *Id.* §§ 167(b), 167(j)(1).

60 *Id.* § 167(j)(5).

61 *Id.* § 167(j)(4).

62 Treas. Reg. § 1.167(b)-1(a).

63 *Id.* § 1.167(b)-2(a).

64 *Id.* § 1.167(a)-11.

65 Act of January 3, 1975, Pub. L. No. 93-625, § 5, 88 Stat. 2108 (1975).

66 Rev. Proc. 62-21, 1962-1 C.B. 418.

67 Act of January 3, 1975, Pub. L. No. 93-625, § 5, 88 Stat. 2108 (1975).

68 Adding to the total confusion, I.R.C. § 167 (k) incorporates a special 60-month rule for elective depreciation of certain expenditures to rehabilitate low-income rental housing. The property is treated as if it has no salvage value which, in a fair number of cases, proves true.

69 I.R.C. § 167(b), (j).

70 President's Tax Message, *supra* note 51, Fact Sheet 15; Taubman & Rasche, Joint Economic Committee, *Subsidies, Tax Law, and Real Estate Investment,* 5 Economics of the Federal Subsidy Programs 343 (1972).

Rules of recapture, requiring characterization as ordinary income rather than capital gain, may come into play on disposition of the building.[71] There is no ordinary income recapture if the building has been held for more than one year and was depreciated on the straight line.[72] If an accelerated method of depreciation was employed and gain is recognized upon disposition, it is ordinary income to the extent of the "excess" depreciation (depreciation taken in excess of straight-line depreciation).[73] In the case of low-income rental housing, however, the burden of recapture is avoided if the property has been held for 200 months and is ameliorated if the holding period is less than 200 months but more than 100 months.[74] When the rental project is heavily encumbered with nonrecourse debt and operating projections have not materialized, for instance the rent role is low and the cost of heating oil high, early foreclosure by the dissatisfied mortgagee will produce frightful tax consequences to the investor who has enjoyed the interim benefits of accelerated depreciation. The amount realized by the limited partnership on foreclosure includes the face amount of the mortgage.[75] Gain, treated as ordinary income under the recapture rules, will flow to the limited partner investor, although he will not receive a penny in cash.[76] Reacting to the risk, investors and their tax advisers design fantastic schemes to avoid recognition of income. Some of these schemes are grounded in very sophisticated or at least very technical analyses of complex tax provisions.[77] Most plans to avoid recognition appear to be grounded on nothing more than the dark-of-night theory. Far too many are likely to succeed: Although increasing in number, the frequency of partnership audits is low,[78] the partnership provisions and other relevant portions of the tax law are complex in application,[79] few revenue agents can shoulder the peculiarly heavy

[71] I.R.C. § 1250.

[72] Under the realty recapture rules, only the depreciation in excess of straight line is subject to recapture if the property is held for more than one year; if the property is held for less than a year, all depreciation is subject to recapture. *Id.* § 1250(b)(1).

[73] *Id.* § 1250.

[74] *Id.* §§ 1250(a)(1)(B), 1250(a)(2)(B). *See generally* Kelly & Aronsohn, *Real Estate Depreciation and Low Income Housing*, 23 Tax Law. 555 (1970).

[75] Note 45, *supra*.

[76] I.R.C. § 702. *See generally* A. Willis, 1 Partnership Taxation 61-86 (2d ed. 1976).

[77] *See, e.g.*, Brode, *Tax Shelter Problem Areas*, 54 Taxes 306, 318-24 (1976); Cowan, *Use of Grantor Trusts To Escape a Tax Shelter Without Detrimental Effects*, 41 J. Tax. 346 (1974); Kanter, *Supplementary Comment on the Defective Trust Gambit*, 54 Taxes 686 (1976).

[78] *See, e.g.*, address by Jerome Kurtz, Intermountain Accounting Seminar (Nov. 16, 1977), *reprinted in* B.N.A. Daily Report for Executives, No. 223, J-4 (Nov. 17, 1977). President Carter has proposed legislation that would permit the Internal Revenue Service to audit partnerships as a distinct economic unit. President's Tax Message, *supra* note 51, Fact Sheet 16.

[79] *See, e.g.*, Roberts, Friedman, Ginsburg, Louthan, Lubick, Young & Zeitlin, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325 (1972).

burden, and the investor plays the tax lottery with high expectation of success.

Simplification

If large investing partnerships were reclassified as associations for tax purposes, the real estate tax shelter would become very largely a monopoly of the rich. This does not seem a convincing reason to make the change. Nor would it inevitably simplify: The large accounting firm or other professional partnership, investing in rental realty as a sideline, would present a problem of either tax characterization or tax avoidance. And, as a practical matter, a blanket rule of this sort could not be adopted unless a direct subsidy alternative to the low-income housing tax shelter simultaneously was adopted.[80]

"At-risk" rules were imposed by the Tax Reform Act of 1976 on specified nonrealty tax shelters and on various partnership ventures other than real estate tax shelters.[81] If "at-risk" rules were extended to realty, the potential impact on tax shelter investment would be enormous. The reasons for this impact constitute one of the reasons why I would not recommend the extension. The size of the impact is a function of the legitimacy of the arrangement. Wholly apart from tax considerations, nonrecourse financing of real estate investment is commercially normal and has been sanctioned by a long and consistent history. Additionally, the extension would be a doubtful blow for simplification. Some investors would undertake actual risk. Many others, advised by the sophisticated or by the uncaring, would shoulder the appearance of full risk but the actuality of limited or no exposure. The self-assessment system is not well served by rules calculated to encourage general expansion of the tax lottery.

Section 189, limiting current deduction of real property construction period interest and taxes, deserves reconsideration. If it is to remain, it ought to apply to all taxpayers, whether corporations or individuals. It is difficult to conceive of a sound reason for why the tax law should grant so great a competitive advantage to the corporate realty developer over the noncorporate developer. The special treatment of low-income housing in this section,[82] as in other Code provisions,[83] would come to a tax-simplifying end if HUD were to be

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80 Even the recent proposal to treat all limited partnerships with more than 15 limited partners as corporations for tax purposes would exempt partnerships primarily engaged in residential real estate. President's Tax Message, *supra* note 44, Fact Sheet 16.

81 I.R.C. §§ 465, 704(d). *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 33-40, 96-97 (1976).

82 I.R.C. § 189(b).

83 *E.g., id.* §§ 167(j), 1250.

allowed and encouraged to implement a direct subsidy alternative. The Congressional Budget Office has suggested six alternatives [84] and quite likely there are others. In terms of tax simplification, any of them is preferable to what we now have.

The depreciation rules impose, perhaps, the greatest burden on the tax system, largely because they proceed in practice from nonneutral, subjective judgments made by the taxpayer. Aggressiveness is too often well rewarded, and the audit burden is far too heavy. If, in fact, accelerated depreciation of new structures does not accord with economic reality,[85] requiring straight-line depreciation would be both logical and tax simplifying.[86] But to complete the task, the subjective method of determining useful life and salvage value must be replaced, insofar as possible, by auditable objective standards. One approach would rely upon the commercial objectivity of the mortgage lender; this seems to me to be questionable in principle and too easily subject to manipulation.[87] A quite different approach would rely upon Treasury guidelines, which, unlike the 1962 guidelines, project economic decline not in terms of years of total useful life, but rather in terms of the percentage of cost expected to disappear by the end of a specified number of years following date of acquisition. If, for example, a guideline states that the current cost of a 10-year-old building of the specified type is 85 per cent of the current cost of an otherwise identical new building, the investor in a new building would be allowed to depreciate 1.5 per cent of his cost each year during the next 10 years. At the close of that term, the investor would consult the guidelines then in use to determine the difference in current selling price of a building of this type that is 10 years old and one that is 20 years old.[88] A convention to deal with repairs and capital improvements would be needed.[89] Whether and over what period of time the Treasury could develop a

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84 CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES (1977).

85 Note 70, *supra*.

86 *Cf.* President's Tax Message, *supra* note 51, Fact Sheet 15:

> Deductions generally will be computed under the straight-line method. However, the 150 percent declining balance method will be permitted for new multi-family housing through 1982, when depreciation will be limited to the straight-line method. Low-income housing will be depreciated under the most accelerated methods through 1982 when it will be limited to the 150 percent declining balance method.

87 *Compare* the distinguishable approach but similar concern noted in BREAK & PECHMAN, FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? 73 (1975).

88 *Compare* President's Tax Message, *supra* note 51, Fact Sheet 15:

> Taxpayers generally will be required to base their depreciation deductions for buildings on the average depreciable lives now in use by all taxpayers as reported in surveys conducted by the Treasury.

89 *Compare* Treas. Reg. § 1.167(a)-11(d)(2).

very detailed guideline system of this sort, and whether and under what circumstances and subject to what limitations the investor would be afforded an alternative "facts and circumstances" test [90] appear to be the key concerns.

Were a system of this or an analogous kind adopted, the requirement of straight-line depreciation would eliminate realty recapture rules for other than transitional matters and, perhaps, for dispositions effected in the year of acquisition.[91] Eliminating ordinary income recapture would remove Section 1250(a) from the Section 751(c) "collapsible partnership" catalog. That elimination almost certainly would substantially simplify an inordinately complex area of tax law.[92]

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[90] *See* notes 65-67, *supra,* and accompanying text.

[91] *Cf.* I.R.C. § 1250(b)(1).

[92] *See generally* 1 A. WILLIS, PARTNERSHIP TAXATION, ch. 27 (2d ed. 1976); Applebaum, *Collapsible-Partnership Danger Increases with Use of Partnerships as Tax Shelters,* 42 J. TAX. 272 (1975); Hewitt & Pennell, *Partnership Taxation: Interest Shifts, Basis Adjustments and Unrealized Receivables,* 38 J. TAX. 219 (1973).

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The Taxation of Compensation Simplification Versus Equity Versus Practicality

William M. Goldstein

If all compensation for services rendered was paid in cash shortly following the performance of the services, the taxation of compensation would be simple indeed. The real world, however, presents a vastly different picture: For both tax and nontax reasons, compensation is frequently paid in kind or deferred or both. The nontax reasons include both governmental and private paternalism; the tax reasons include the benefits of deferral, special treatment, and outright exemption.

In terms of dollars, the biggest issue in this area is, of course, the tax treatment of deferred compensation distributed through "qualified" pension, profit-sharing, and stock-bonus plans. In 1976, employer contributions to private plans of this type were estimated at $29.1 billion; earnings on such plans were estimated at $10.4 billion; and benefits paid out were estimated at $19.4 billion. Although involuntary, social security retirement benefits complement and supplement the private pension system and raise similar tax questions. Other significant benefits to be discussed herein include employer-provided health and disability insurance; Medicare and Social Security Disability Insurance; employer-provided life insurance coverage; unemployment compensation; and the entire panoply of so-called fringe benefits paid in kind.

In terms of simplification, the ideal solution would be to tax all of the above items in the same manner, at least to the extent that they, themselves, are the same. Continuing in this vein, the simplest solution would be to value all benefits at the time they are provided as if cash had been passed and the employee, in turn, had purchased the item, that is, an annuity policy, term-life insurance, health insurance,

* William M. Goldstein is a member of Morgan, Lewis & Bockius, Washington, D.C.

an airplane ticket, and so forth. If the employee has no immediate right to the benefit, taxation would be deferred until such right vests.

Alternatively, a fairly simple system would be to defer both employer deductions and employee income until the employee receives cash or its equivalent, that is, a pension distribution, life insurance proceeds, health insurance payments, airplane tickets, and so forth. Of course, payments in kind would still pose serious valuation problems.

The difficulty, of course, is that the foregoing "simple" solutions run directly counter to other major factors considered in determining tax policy, such as Congressionally mandated "social goals"; perceptions of "equity"; and administrative feasibility. In considering the various types of compensation, we shall briefly review the current treatment; the suggested "simple" solutions; some solutions suggested by others; and the impact of the cross-currents of public policy, equity, and practicality.

PRIVATE RETIREMENT BENEFITS

Under present law, if a retirement plan is "qualified," the employer's contributions to the plan are deductible when made, no one is taxable on plan income, and an employee is taxable when he receives distributions attributable to such contributions and income. In addition, if the employee contributes to the plan, his contributions are not deductible, but the earnings thereon are not taxed; and he may exclude his contributions when distributions are taxed. Finally, certain lump sum distributions are taxed as capital gains.[1]

There is no doubt that the foregoing tax treatment is extremely favorable and has contributed to the dramatic growth of private pension plans. As recently as 1974, Congress reviewed the entire area of private pension plans when it adopted the comprehensive Employees Retirement Income Security Act; despite criticisms of the cost and complexity of this Act, there seems to be uniform support for the basic tax treatment of pensions under ERISA. In addition, the tax-induced savings under the private system are a major element in capital formation in the private sector.

If all compensation were taxed to employees when vested, an employee would pay tax on the present value of anticipated future benefits when accrued. This process would be quite complex in the case of defined-benefit plans. Rather than pay tax on dollars that they did

[1] I.R.C. §§ 401-404.

not receive, employees would presumably forego pension benefits for higher current compensation. If this were the result, the tax law would certainly be simpler, but would such simplification be worth the cost in terms of capital formation and expanded public pension programs?

In *Blueprints for Basic Tax Reform*,[2] the Treasury Department, under William Simon, suggested that many of the complexities of taxing pension benefits as they accrue could be avoided by taxing the plan's earnings (to the employee, if vested, and to the employer, if not) and fully taxing distributions.[3] *Blueprints* demonstrates that this scheme, despite the apparent double taxation of plan income, has the same net effect as taxing accrued benefits plus plan income. In any event, this plan would also raise havoc with the private retirement plan as we now know it.

The other "simple" solution suggested above would be to deny deductions to the employer until benefits were paid and taxed. Plan income would be taxed to the employer. This scheme would be even more destructive of qualified plans than the two preceding ideas; this is because the revenue gain from denying the employer's deduction would exceed that from taxing accrued benefits.

In the *Tax Reform Option Papers*,[4] recently published by the Treasury Department, only modest changes and precious little simplification were proposed in the area of qualified retirement plans. Contributions by 10 per cent shareholders would be limited to $7,500 per year; the maximum limitation on defined benefit pension plans would be reduced to $60,000 per year, with no cost-of-living adjustment; the amount that would be contributed for any employee under a defined contribution plan would be limited to $15,000, with no cost-of-living adjustment; and so forth.[5] These proposals represent the quintessence of "tinkering," have little to do with reform, and, on balance, probably add to complexity.

Where then are we? In terms of broad principles, "simplification" would mandate either taxing accrued benefits or denying employer deductions. In this way, pension benefits could thereby be most easily treated uniformly with all other employee benefits. The details of taxing accrued pension benefits would not be at all simple, however, and denying employer deductions would sound the death knell for

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[2] DEPARTMENT OF THE TREASURY (1977) [hereinafter cited as BLUEPRINTS].

[3] *Id.* at 56-57.

[4] DEPARTMENT OF THE TREASURY, TAX REFORM OPTION PAPERS (1977) [hereinafter cited as the TAX OPTION PAPERS]. (Page references are to the BUREAU OF NATIONAL AFFAIRS, (Oct. 7, 1977)).

[5] *Id.* at 38-39.

funded plans. John Nolan has recently commented on this apparent conflict between general principles of simplification and the specific Congressional mandate to encourage private pension plans:[6]

> Substantial simplification would be achieved, in general, by enlarging the tax base to include in income all economic benefits arising out of the employment relationship. A comprehensive tax base permits a substantially reduced and simplified structure of exemptions and rates, which would be the greatest possible contribution to simplification. *Blueprints,* for example, demonstrates that with a comprehensive tax base, roughly the same degree of progressivity in the income tax system, or vertical equity, may be achieved with a greatly-simplified [and reduced] structure of exemptions and rates.
>
> On the other hand, the major identifiable and integrated set of benefits reflected in the treatment of qualified employee benefit plans could be excluded from the all-inclusive concept of income without major loss of these simplification achievements. The policy considerations favoring encouragement of retirement savings through the private sector, with the benefits of flexibility thereby obtained, may be of greater importance.

Despite the anomaly of commencing a paper on simplification with a proposed exception to our search for general rules, there is much to be said for Nolan's approach. As a matter of practical politics, of course, there really is no other approach. In any event, much can be done to simplify and streamline ERISA, and not by the timid approach of the *Tax Option Papers.*

SOCIAL SECURITY RETIREMENT BENEFITS

Under present law, employers may deduct the social security taxes that they pay.[7] Employees may not deduct social security taxes that are withheld and paid over by their employers.[8] Retirement benefits are not taxable, and, of course, there is no attempt to tax earnings on the social security "trust fund."[9]

Any attempt to tax benefits as they accrue would be at least as complicated as in the case of private pension plans. Also the employee tax would have to be allowed as a deduction. The simplification technique of delaying all deductions and taxing all benefit payments does not make sense in the context of social security, that is, all of the

[6] Nolan, *Taxation of Fringe Benefits,* 30 NAT'L TAX J. 359, 360 (1977).
[7] I.R.C. § 162.
[8] *Id.* § 3502.
[9] Rev. Rul. 70-217, 1970-1 C.B. 12.

employers who ever contributed with respect to an employee would have to be allowed a prorated deduction when benefits were paid.

Blueprints would allow a deduction for all contributions (that is, employee as well as employer taxes), and tax all benefits. It does not, however, seek the equivalent of accrual by taxing fund earnings.[10] The distinction is based on the mandatory nature of social security, which does not, says *Blueprints*, create an incentive to convert savings into tax-deferred forms.

The *Tax Option Papers* consider taxing social security retirement benefits but only if the taxpayers' other income on a joint return exceeds $20,000 or $35,000; no mention is made of allowing the employee to take a deduction for his tax payments.[11] The Treasury recommends against even this minor departure from the present exemption. Simplification does not seem to be an important consideration.

On balance, the *Blueprints* solution seems most acceptable. It is, in fact, simple; and it is consistent with the present treatment of private retirement plans. Finally, it comes much closer than the present system to achieving the base broadening that is essential to both simplicity and equity. Presumably, the Code's pattern of rates and exemptions would be structured to exempt persons whose income includes *only* social security retirement benefits.

EMPLOYER-PROVIDED HEALTH INSURANCE

Under present law, employers can deduct health insurance premiums; employees do not have corresponding income; and benefit payments are nontaxable.[12] This highly favorable treatment presumably encourages the purchase of this type of insurance, which is regarded as socially desirable. This scheme is certainly simple, but is it consistent and is it fair?

It would pose no undue complexity to require employees to pay tax on health insurance premiums paid by their employers. Since similar coverage is offered on an individual basis, the value of the coverage received is easily measured and easily taxed. Benefit payments would then, presumably, be tax-free, and the employee would be able to deduct the amount of his imputed income as if he had purchased an individual policy.[13]

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10 BLUEPRINTS, *supra* note 2, at 58.
11 TAX OPTION PAPERS, *supra* note 4, at 34-35.
12 I.R.C. §§ 106, 162.
13 *Id.* § 213(a)(2).

The *Blueprints* program would include in taxable income health insurance premiums paid by an employer.[14] This, of course, appears inconsistent with delaying the tax on retirement benefits until received; but the distinction can, perhaps, be justified by citing premium taxation as the general rule and pensions as an exception justified by the complexities involved in allocating the cost of private and social security retirement benefits. Another reason why there is little enthusiasm for taxing health insurance *benefits* is that a serious illness could produce an unreasonable increase in income in the year in question. This problem might, however, be handled by allowing a deduction for catastrophic medical expenses.

Taxing health insurance premiums leads us, for the first time, into the wholesale-retail dilemma in the fringe benefits area. If the cost to the employer of a group health insurance program is less than the sum of the individual policies, should this cost saving be allocated and passed on to the employees? Presumably, the problem would be solved in the same manner in which the cost of employer-provided group term life insurance in excess of $50,000 is presently derived.[15]

In summary, since true simplicity requires taxing all income wherever possible, it would seem that health insurance premiums should be taxable.

MEDICARE

A portion of the social security taxes provide funding for health benefits that closely resemble those paid under private health insurance programs; the only significant difference is that the recipient must be over age sixty-five. Since employer-paid taxes provide one half the cost of this system, the resemblance to private health plans is obvious. A parallel solution would be to tax the employees on that portion of the employer's social security taxes that is used to fund Medicare, and *Blueprints* apparently recommends this procedure.[16] I would, reluctantly, disagree on the grounds of complexity and impracticality and offer the involuntary nature of the program as a basis for distinction. I would thus favor taxing Medicare *benefits*, like social security retirement benefits, but with offsetting deductions for medical expenses to the extent that these deductions remain in the Code.

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14 Blueprints, *supra* note 2, at 59.

15 *See* I.R.C. § 79 and the regulations thereunder.

16 Blueprints, *supra* note 2, at 59.

EMPLOYER-PROVIDED DISABILITY INSURANCE

Employers may deduct premium payments, but employees do not realize income at the time of these payments. Disability benefits are not taxable except in excess of specific limits.[17]

Blueprints suggests treating disability and health insurance provided by employers in different ways. It concludes that taxing disability premiums to the employees would pose insurmountable administrative difficulties and recommends full taxation of benefits.[18] It is difficult to appreciate this distinction from health insurance.

Individual disability policies, like individual health policies, are sold every day, and the same type of extrapolated valuation should be possible. Also when explaining the rough equivalence between taxing disability payments and taxing disability premiums, *Blueprints* states that: "The expected value of tax is approximately equal to the tax liability under a current accrual taxation system." If this is so, why does *Blueprints* suggest taxing pension fund earnings twice? Not being an actuary, my guess is that the insurance company's costs and profit roughly equal the income tax on current pension fund earnings—*mirabile dictu*!

In the *Tax Option Papers*, it is recommended that employers be allowed deductions for disability, as well as health, insurance premiums only if the plan does not discriminate in favor of officers, shareholders, and higher paid employees.[19] This requirement does not provide any "simplification," but it is probably an acceptable parallel to ERISA requirements.

On balance, it seems most consistent with the concept of taxing all compensation for services to tax the beneficiaries of disability insurance on their ratable share of premium payments. Benefit payments would then be nontaxable, as in the case of individually purchased policies.

SOCIAL SECURITY DISABILITY INSURANCE

Once again, the employers' tax is deductible, but no income is allocated to potential beneficiaries at that time. Benefit payments are tax free. Both *Blueprints* and I would tax benefits for the same reasons that I have suggested for taxing all other social security benefits.[20]

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17 I.R.C. § 105(d).
18 BLUEPRINTS, *supra* note 2, at 59.
19 TAX OPTION PAPERS, *supra* note 4, at 37-38.
20 BLUEPRINTS, *supra* note 2, at 59.

LIFE INSURANCE

Under present law, life insurance premiums are generally nondeductible and proceeds are nontaxable. If an employer pays life insurance premiums and the employee can designate the beneficiary, the employer may deduct and the employee is taxed on the premium payments, with one important exception.[21] An employer's premium payments for up to $50,000 of group term life insurance are tax free to the employee.

Under the *Blueprints* program,[22] term insurance would be taxed the same as under present law, except that the $50,000 exclusion would be removed. In the case of whole life or permanent insurance, however, the owner of the policy would be taxed each year on an amount equal to the increase in its cash surrender value, plus the value of the term insurance protection, minus the net premium. It is not made clear whether the mere right to designate the beneficiary would shift this tax to the employee or whether there would be some concept of "vesting."

Blueprints explains that the increasing cash surrender value represents the increasing value of the insured's right to purchase the same amount of insurance each year at a fixed premium. Others would contend that the insured is being taxed on the earnings on the "investment element" of his policy. In either event, a new item is added to the tax base that resembles the income that the policyholder would have realized if he had instead bought decreasing term insurance and invested the premium savings in a mutual fund.

The *Tax Option Papers* recommend reducing the $50,000 group-term exclusion to $25,000 [23] and limiting it to plans under which the coverage and benefits do not discriminate in favor of officers, shareholders, or higher paid employees.[24] Taxing the interest earned on the savings element of cash value life insurance is also considered, although it is again not made clear who would be considered the taxable "policyholder" under various types of employee plans. The measure of taxation is expressed somewhat differently from *Blueprints*, but it might amount to the same thing: The amount includable in a policyholder's income each year would be equal to the annual increase in the cash surrender value of his policy, less the annual net premium allocable to the cash surrender value. The applicable portion of the annual net premium could be calculated from a standard table prescribed by the IRS. It is also suggested that the insurance company be required to withhold 20

[21] I.R.C. §§ 79, 101, 264; Treas. Reg. § 1.61-2(d)(2)(ii)(a).

[22] Blueprints, *supra* note 2, at 60.

[23] Tax Option Papers, *supra* note 4, at 41.

[24] *Id.* at 42.

per cent of the amount taxable to its policyholders and report the gross income and withholding on information returns.

After discussing the pros and cons of taxing this element of gross income, the Treasury recommends against taxing this interest "because of the probable strength of industry opposition." [25] As a matter of tax policy, it is submitted that the "cons" are insubstantial and that industry opposition should yield to considerations of consistency, simplification, and equity. Opponents of this proposal have argued that requiring insurance companies to identify this income and policyholders to report it is adverse to simplification. It is submitted, however, that the burden on this fully computerized industry would be minimal and that the benefit to the broad concept of simplification, taxing all income, would be quite substantial.

The preceding discussion goes somewhat beyond the topic of employer-provided benefits; but the broader topic must be considered in order to strive for equal tax treatment of all of these types of benefits. If the employer pays the whole life premium and the employee is taxed on it, he should also be taxed on that year's cash value earnings, as long as he benefits therefrom in terms of less expensive coverage or vested rights upon cancellation. The balance, if any, of this income should be taxed to the employer. There seems to be no overriding policy reason to continue the group term exclusion at any level.

UNEMPLOYMENT COMPENSATION

Although the system is mandatory, unemployment compensation seems properly includable in this discussion of employer-provided benefits. While the employee is working, the employer must provide for future benefits if the work should cease under certain circumstances. Under present law, unemployment taxes are deductible by the employer, but income to the employee is not. Unemployment benefits are not taxable to the recipient.[26]

Blueprints favors taxing unemployment benefits, rather than allocating tax payments,[27] and I agree. Here again, we are dealing with an involuntary plan under which allocation would be quite difficult, that is, unemployment insurance is not customarily sold on an individual basis. Besides, an individual with $5,000 of unemployment compensation as part of his income should be treated in the same way as one

[25] I.R.C. § 162.
[26] Rev. Rul. 73-154, 1973-1 C.B. 40; Rev. Rul. 70-280, 1970-1 C.B. 13.
[27] BLUEPRINTS, *supra* note 2, at 61.

receiving a like amount of social security retirement or disability income. It would appear that some consistent patterns are emerging here and that this is certainly a step toward simplification.

OTHER STATUTORY "FRINGES"

The most important types of deferred or noncash compensation for which treatment is provided by the Internal Revenue Code are discussed above. But there are other kinds of deferred or noncash compensation excluded from income by statute, as, for example, medical expense reimbursement plans; [28] qualified group legal services plans; [29] combat pay; [30] mustering-out pay; [31] certain retirement pay of members of the armed services; [32] fellowship grants; [33] veterans' disability, survivor, and pension benefits; [34] and the rental value of personages.[35] An even better known, frequently used example is meals and lodging furnished for the convenience of the employer.[36]

In terms of simplification, it seems desirable to tax all of this income, unless it falls into some exception to be discussed below in connection with nonstatutory fringes, such as a *de minimis* exception in the case of the nominal value of meals or the excess "value" of housing furnished to employees living abroad. The policies that have led to these additional statutory exclusions seem insubstantial in the face of any real effort to broaden the tax base and consistently tax compensation.

"FRINGES" UNDER THE REGULATIONS

The income tax regulations exclude certain employee benefits from income for reasons that are not entirely clear under the statute. For example, tuition remission programs for children of faculty members of educational institutions are treated as "scholarships," excluded from income by Code Section 117.[37] On November 1, 1976, the Treasury Department proposed changes in the regulations to include these tuition remission benefits in income.[38] The regulations were subsequently with-

[28] I.R.C. § 105(b).
[29] *Id.* § 120.
[30] *Id.* § 112.
[31] *Id.* § 113.
[32] *Id.* § 122.
[33] *Id.* § 117.
[34] *Id.* § 104.
[35] *Id.* § 107.
[36] *Id.* § 119.
[37] Treas. Reg. § 1.117-3.
[38] Notice of proposed rulemaking, 41 Fed. Reg. 48, 132 (1976).

drawn in a storm of protest.[39] The regulations also exempt military subsistence and uniform allowances from tax. Except for their origin, the problems posed by these exclusions seem no different from those involving "fringe benefits" in general; hence they will be considered below.

ALL OTHER "FRINGES"

The final group of benefits to be considered includes all of those benefits that have been excluded from income by published rulings or administrative practice, sometimes on the ground of administrative convenience, or the tax treatment of which is uncertain and frequently varies according to audit practices of the Internal Revenue Service. These include airline and railroad passes given to employees,[40] discounts allowed to employees of retail stores, personal use of company cars, free parking, and many other items. In September 1975, the Treasury Department released a discussion draft of proposed regulations that, in general, attempted to rationalize and continue the long-standing administrative practice of excluding many of these employee benefits from income.[41] The draft was the subject of spirited protest, both by opponents and by proponents of various exclusions, and the draft was subsequently withdrawn.[42]

In considering the proper treatment of the foregoing items from the point of view of simplification, administration is an overriding consideration. Because these benefits are so pervasive and varied, a complex system, fraught with problems of valuation, identification, and consistency, would be intolerable to both taxpayers and the Internal Revenue Service. On the other hand, as has been stressed often in the preceding discussion of the better-known statutory fringe benefits, the general principle must be to tax all income. This is required by simplicity in its broadest sense, equity, and consistency. Exceptions to this general rule should be rare and clearly defined, and the solutions to problems of valuation should be clear and simple.

John Nolan has dealt with the questions of exceptions and valuation in his excellent article, *Taxation of Fringe Benefits*.[43] Since I agree

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39 I.R. 1735 (Jan. 13, 1977), *reprinted in* [1977] DAILY TAX REP. (BNA) No. 9, at G-11.

40 O.D. 946, 4 C.B. 110 (1921).

41 Discussion Draft of Proposed IRS Regulations Relating to Treatment of Fringe Benefits, 40 Fed. Reg. 41,118 (1975) [hereinafter referred to as the draft, or discussion draft], Announcement 75-101, 1975-40 I.R.B. 22.

42 Department of the Treasury, News Release (December 17, 1976).

43 Note 6, *supra*.

with his conclusions, it seems easier to summarize them than to reinvent the wheel.[41]

VALUATION

The various methods that have been suggested include: (1) objective fair market value; (2) subjective fair market value; (3) incremental cost to the employer; and (4) fair market value less arbitrary discounts. Objective fair market value raises some problems and calls for some exceptions, but it is the only acceptable standard for this broad range of problems. In addition, it seems mandated by Code Section 83.

Subjective fair market value, that is, what the employee would give up in cash compensation to obtain the benefit, is interesting but totally impractical. Incremental cost, a concept highly favored by the 1975 discussion draft, would lead to total or near total exemption for items such as airline passes and department store discounts. This principle, if carried to extremes, could lead to grave inequities in our system, if it has not done so already. In any event, it runs counter to the statute. The latter reason may also apply to arbitrary discounts, which would also involve constant controversy over the proper level of discounts in various situations.

We are thus left with objective fair market value as our guiding principle. The remaining questions relate to the application of this principle in a variety of real life situations.

(1) *Benefits that are primarily provided to aid the business of the employer and constitute acceptable conditions of employment.* In these cases, the objective value of the benefit usually far exceeds its subjective benefit. These arguable "fringes" are difficult to articulate but are fairly recognizable as examples. Nolan suggests that they remain nontaxable, and I agree. This category includes: (a) an executive's large, attractive office; (b) first-class air travel to facilitate work or to eliminate fatigue; (c) a limousine if, in fact, used as a portable office; (d) free annual physicals to minimize sick time; (e) a bodyguard; (f) bus service for night-shift employees, if the area is unsafe and public transport unavailable; and (g) free parking in a suburban or rural area.

(2) *Benefits that contain some of the elements of the foregoing but go beyond acceptable conditions and primarily benefit the employee.* Obviously, the line between these categories is hard to draw, but the following benefits would be taxable: (a) parking in an urban area,

[41] Certain page references and quotation marks have been omitted in the following discussion.

except where the employee uses his car to a substantial extent on employer business during normal working hours; [45] (b) the value of a week's accommodations at a resort location for a "meeting" of company employees, when, in fact, the social and recreational elements clearly outweigh the business elements of the meeting; and (c) a limousine used primarily for commuting and pleasure, but where the executive occasionally does some work.

(3) *Benefits that can be readily split between the two preceding categories.* Sometimes it will be possible to draw a line between what should be a taxable benefit to the employee and the "excess," which is either provided for the employer's benefit or necessary to make the employment acceptable (really the same thing, I think). Consider the case of housing provided to overseas employees in certain areas of countries such as Saudi Arabia, where American-style housing is not otherwise available. A simple apartment that might rent for $400 per month in the United States might command a rental of $2,000 per month in this kind of an area. The provision of accommodations to employees and their families who are United States citizens may properly be viewed as providing acceptable conditions of employment by generally prevailing community standards. On the other hand, there is a clear benefit to the employee, and, except where the specific standards of Code Section 119 are satisfied [46] so that the amount is specifically excluded from income, the employee should be taxed on some amount. A reasonable solution would be to include in his income the fair rental value of comparable facilities in the area of his permanent residence in the United States.

Another good example is company-provided cars that are available for personal use. There are identifiable, measurable benefits to the employee that are sufficiently substantial to be taxed. The regulations might address the case of an automobile normally used five days per week in business to a substantial extent, in addition to being used for commuting [47] and on weekends by the employee for his personal use. It might be reasonable and administratively feasible to prescribe by regulation a general standard under which one third of the annual rental charge for a comparable car by a commercial lessor of cars would be treated as income to employees.

Similarly, it might be feasible to prescribe rules in the regulations for

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45 *See* Nolan, *supra* note 6, at 367.

46 Treas. Reg. § 1.119-1(b).

47 It is well settled that commuting expenses of employees are not deductible. Accordingly, it follows that in-kind benefits to employees that replace commuting expenses should be taxed. *See* Rev. Rul. 76-453, 1976-2 C.B. 86, and cases cited therein.

the value of housing allowances for overseas employees in areas where housing similar to that in the United States is not readily available. These rules might prescribe arbitrary values for various sizes of housing, including separate values for multi-family and detached housing and excluding lavish and unusual accommodations, that would represent the amount that would be deemed income to these employees. These values would be based on average or somewhat lower-than-average costs in the United States for the same kind of housing.

These arbitrary rules would greatly simplify the administration process without significant loss of equity, as compared with the uneven results that occur under existing law.

(4) *Some special cases.* Some problems occur with sufficient frequency that special rules, rather than general guidelines, might be provided. In the case of airline and railroad passes, it would not be fair to tax at tourist rates if the actual pass basis is "seat available." Every effort should be made to find true fair market value through comparability. In the case of department store discounts, the relevance of "sales" and discounts available to nonemployees should be taken into account in valuing the employee's discount. Tuition remission is a very difficult case; the answer may lie in the use of actual scholarship programs based on need, rather than remission benefits available to all faculty. Finally, there is the wholesale-retail problem, referred to above in the context of group insurance purchases. I believe that this problem is different from that of incremental cost and that employees should get the benefit of volume purchase discounts from third parties. This is because the employees, in most cases, could form a "group" or cooperative and obtain similar volume discounts.

Other special, difficult problems discussed by Nolan include supper money and schooling provided for children of overseas employees. He states: [48]

> There are hard cases which do not fall clearly on either side of the "acceptable conditions of employment" baseline. Consider the employee who receives supper money reimbursement. If the employee has been required or requested by the employer to stay beyond normal working hours and after the supper hour, and is reimbursed only for reasonable expenses actually incurred, the amount can and probably should, both on conceptual and administrative feasibility grounds, be excluded from income. Under these conditions, such reimbursement would be regarded as an acceptable condition of employment by generally-prevailing community stan-

[48] Nolan, *supra* note 6, at 365.

dards, not a benefit to the employee. The value to the employee ordinarily would be substantially less than the cost of such a meal.

On the other hand, if the employee's normal work period spans the supper hour and he is regularly reimbursed for supper, even if only for reasonable expenses actually incurred, the amount is a measurable benefit which is not a normal condition of employment, and it should be taxed. Once again, the simplification problem may be addressed by prescribing clear principles which draw these distinctions.

An even more difficult case is the example in the Discussion Draft regulations of a corporation maintaining American-style schools for children of employees at overseas locations where either local schools are not available or are not comparable to American schools. The Discussion Draft regulations would not have taxed the value to the employee-parents on the ground that the school provides benefits similar in nature to services provided in the U.S. by local governments. This rationale is not entirely clear; presumably it implies there is no benefit to the employee—that this is merely providing acceptable conditions of employment.

This result seems sound, however, so long as there are no acceptable schools otherwise available for the children of the overseas employees. This is merely providing acceptable conditions of employment under the conditions stated. This could be dealt with explicitly in regulations.

INCOME AND DEDUCTIONS

In terms of simplification, in the area of compensation it is clear that the tax result should be the same, regardless of whether the employer provides the benefit or reimburses the employee who has purchased it. If the employee has received cash and cannot fully deduct the cost of the benefit, he should not be able to exclude the income. We supported this result in the case of health insurance, above, and would reach the same conclusion in the case of employer-provided child care and commuting costs. The employee should report the value of the benefit as income and then take whatever deductions are allowed. Other examples include interest-free loans; matching charitable contributions; medical expense reimbursement plans; and group legal services where, for example, the employee gets tax advice.

A ROLE FOR *DE MINIMIS*

In the preceding pages, we have argued for a greatly expanded concept of compensation income compared to what is required by the current

Code, regulations, and administrative practice. If simplification is one important objective, however, this quest for includability and consistency can prove self-defeating if carried too far. The year-end search for covert compensation could prove exhausting, and the review on audit could be even more troublesome. At some point, despite Code Sections 61 and 83, enough should be enough.

In the past, the Service has ruled that the value of hams, turkeys, and other nominal Christmas gifts to employees need not be included in income.[49] Nolan suggests that a series of *de minimis* rules be established to minimize recordkeeping for a variety of minor fringes that do not aggregate to a significant amount of increased income, such as store discounts of less than $100 per year.[50] Purists will not tolerate these rules if they come via administrative fiat, but the Code could be amended to authorize these exceptions through regulations, with such limits as Congress might deem appropriate. It would seem that this might be a very useful step in obtaining support for the broadest concept of taxable compensation income from those employees who really derive very little benefit from the present system.

A TAXABLE FRINGE IS BETTER THAN NO FRINGE AT ALL

One point that is almost always overlooked in the heat generated by the subject of taxing employee benefits is that a taxable benefit is still usually a considerable boon. It would be very rare indeed for the employee to prefer no benefit at all to a taxable one and, in terms of vertical equity, it is particularly significant that the lower paid employees would derive the greatest after-tax benefit from the fringes in question. A 15 per cent discount to a department store employee is still a 12 per cent net discount even if taxed at a marginal rate of 20 per cent; and $4,000 worth of "free" air travel is still quite a deal, even if the flight attendant must pay the IRS $1,000. If, on the other hand, a top executive does not think that it is worth 50 per cent of the imputed cost of a private jet flight to bring his wife to a convention, he will not choose this mode of travel. Full recognition of the fairly obvious thrust of this paragraph should make the balance of this paper's "radical" proposals less objectionable, particularly if, as *Blueprints*, Nolan, and this writer[51] have urged, the tax base is generally broadened and rates lowered.

[49] Rev. Rul 59-58, 1959-1 C.B. 17.

[50] Nolan, *supra* note 6, at 366.

[51] Goldstein, *An Overview of Basic Tax Reform Possibilities*, 14 Hous. L. Rev. 1059 (1977); *The Case for a Tax on Gross Income*, 30 Nat'l Tax J. 225 (1977).

CONCLUSION

In developing a comprehensive approach to the taxation of compensation other than current wages and salaries, there is no reason to distinguish among items presently exempted by statute, regulations, rulings, or administrative practice, except, perhaps, in formulating transition rules. All benefits should be fair game and current taxability the strong presumption. Feasibility of administration is an important consideration, however, as is fairness in valuation. The former consideration dictates taxing social security and unemployment benefits, rather than allocating employer tax payments, while the latter consideration suggests a zero valuation for parking space at a plant in a rural location.

Exceptions should be few and far between. The only major statutory exception recommended herein is the continuation of the present favorable treatment of employer-provided retirement benefits. The regulations would also exempt certain items where compensation is not the primary motivation or effect, as, for example, in the case of bodyguards, free physical exams for broad classes of employees, and free schooling in countries where no schools similar to those in the United States exist. Finally, *de minimis* rules may be used to mitigate the recordkeeping and audit burdens when relatively small, cumulative benefits are the issue.

Implementing the above recommendations would simplify the Code by eliminating many present provisions that exclude, in whole or in part, certain types of compensation from income. On the other hand, new rules would have to be prescribed, for example, for taxing the annual interest accrual in cash-value life insurance, and new tables would be needed to set forth the value of employer-provided health and disability insurance. Most important, to deal with the broad range of present nonstatutory benefits, a comprehensive regulation setting forth a framework of principles and clear guidelines, liberally illustrated by specific examples, would be needed to achieve simplification. *Blueprints* did not deal with this last issue, the 11 rulings not quite issued by the last administration were not nearly comprehensive enough, and the discussion draft employed too many conflicting principles in attempting, in general, to support the status quo.

This paper and the article by John Nolan, however, point the way to real simplification by emphasizing includability, objective fair market value, and administrative feasibility. As the title of this paper suggests, "simple" simplification does not come easily in this area, which affects

almost every taxpayer and involves hundreds of different fact patterns; considerations of equity and practicality will frequently dictate that the simplest solution is not always the best solution. On the other hand, objections that amount to no more than the querulous moanings of affected interest groups must be disregarded if real progress toward simplification is to be achieved.

I

Depreciation, Investment Tax Credit, Capitalized Versus Deductible Expenditures, and Prepaid Expenses

Howard G. Krane

INTRODUCTION

> Tax complexity means different things to different people. For some, it means being unable to understand the basic filing requirements or to comprehend forms and instructions. For others, it means having to maintain records, consult a tax practitioner before engaging in a transaction for fear of the tax consequences, and obtain professional assistance in preparing a tax return. For still others, complexity means uncertainty of statutory language.[1]

The goal of simplifying our tax system has been discussed for many years, but little, if anything, has been done. A striking example of this attitude in the public sector can be seen by perusing the so-called Tax Reform Act of 1976, which significantly complicated the Internal Revenue Code. One commentator has described the most recent reform act as follows:

> [T]he recent legislative effort looks far less like tax reform, and far more like an ancient Chinese anagram, drafted in the middle Korean tongue, than should be allowed to see the light of day by responsible legislators. Probably the most striking irony of the entire 1976 legislation was inclusion of a tax simplification title in the final version of the Act, containing a pitifully small number of provisions, most of which were far more complex than the sections they supplanted. While the 1976 Act had much to say about many

* Howard G. Krane is a member of Kirkland & Ellis, Chicago, Illinois.

[1] STAFF OF THE JOINT COMMITTEE ON TAXATION, ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS, A REPORT PREPARED PURSUANT TO SECTION 507 of PUB. L. NO. 94-455 (TAX REFORM ACT OF 1976), 95th Cong., 1st Sess. 3 (1977).

aspects of the federal tax system, simplification was clearly not one of the topics covered.[2]

Simplicity should accomplish several objectives. First, the law should be simply stated and easy to comprehend. Second, it should foster easy compliance by taxpayers. Third, it should lend itself to easy administration by the Internal Revenue Service. And finally, it should avoid spawning controversy and litigation. Given these objectives, this paper discusses simplification in the areas of depreciation methods, the investment tax credit, the classification of expenditures as either a current deduction or a capitalized item, and prepaid expenses. In the course of preparing this paper, a number of tax managers of various size public and private corporations were contacted and asked about their experience with each of the subjects. In addition, the tax return preparation partner of a small accounting firm, servicing over 100 closely held corporations ranging in sales from $200 thousand to $20 million, was also interviewed at length.[3]

DEPRECIATION AND THE INVESTMENT TAX CREDIT—OVERVIEW

Before turning to a consideration of possible simplification alternatives, a few comments are in order about what taxpayers do about depreciation and the investment tax credit. The survey of tax managers and preparers, although not conducted according to sophisticated sampling techniques, showed the following behavior among taxpayers:

(1) Most large corporations use the Asset Depreciation Range ("ADR") rules for depreciation but not for repairs. The main reason for not following the ADR rules in regard to repairs is the extensive recordkeeping and filing requirements.

(2) Most smaller taxpayers do not use ADR, but rather rely on facts and circumstances and tailor their useful life selection either to

[2] Eustice, *The Tax Reform Act of 1976: Loss Carryovers and Other Corporate Changes*, 32 Tax L. Rev. 113, 160 (1977).

[3] Originally, the paper was also to consider the possibility of whether one or more safe-harbor provisions might make sense for travel and entertainment expenses. The interviews mentioned in the text indicated that this area was not a source of controversy or litigation and was rather easily handled on audit. This was particularly true with regard to publicly held corporations or large privately held corporations, where much of the travel and entertainment expense was incurred by persons other than the shareholders. If simplification makes sense here, it may be a simplification designed to ease both the reporting and the auditing of these kinds of expenses. For example, although company-sponsored credit cards are widely used today, many taxpayers allocate the reimbursed travel and entertainment expenses to various office accounts, rather than to one single account. If all of these expenses and substantiation were maintained in one account, it would greatly simplify the auditing of these expenses and the ferreting out of possible abuses.

(a) shorter lives than ADR, relying either on the audit lottery or the fact that if audited, the longest lives they will end up with are the ADR guideline lives or (b) longer lives than ADR if there are special circumstances, for example, anticipated loss expirations. Also many of these taxpayers often take a seven-year useful life, even when a shorter life is easily justifiable, in order to get the full investment tax credit.[4]

(3) The major complexity in the investment tax credit arises from the limitation on taxable income, causing many taxpayers to resort to the complex leasing provisions of the Internal Revenue Code in order to get the benefit of the credit by essentially selling it. This, of course, imposes a transaction cost on those taxpayers and thus reduces, to some extent, the benefit of the credit.

With these facts in mind, let us turn first to a discussion of depreciation and then to a discussion of the investment tax credit. Although tax policy is beyond the scope of this paper, it is a limiting factor in any simplification proposal. Accordingly, although this paper will not analyze the wisdom of existing tax policy, the proposals for simplification discussed will be tested against the framework of existing policy.

DEPRECIATION

The various depreciation methods, coupled with the depreciation recapture provisions, are consistent with the general complexity of our tax system. Depreciation deductions are allowed by Section 167 of the Internal Revenue Code of 1954, as amended, and its corresponding regulations. These provisions permit taxpayers to treat as an expense in determining taxable income an allocable part of the cost of business assets that have a limited useful life. The traditional rationale for allocating the recovery of the cost of an asset over a period of years is so that income can be clearly reflected.[5] Thus, for example, under the

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[4] The facts gleaned from the informal survey have been generally confirmed by the Treasury in President Carter's proposed Tax Reform and Reduction Bill of 1978, in which, in connection with the proposed simplification of ADR, it is stated that only ½ of 1 per cent of all corporate taxpayers elected ADR in 1974, although over 90 per cent of taxpayers with depreciable assets in excess of $1 billion elected ADR. Fact Sheet 32.

[5] The entire purpose of a depreciation allowance is to ascribe the cost of an asset to an annual accounting period. On the other hand, if the income tax were imposed over the entire useful life of an asset, the measurement of depreciation would be simple. It would merely represent the excess of the original cost of the asset over the final disposition price or zero in the case where the asset is abandoned. This puts to one side the issue of whether there should be adjustments to take into account inflation over a period of time. The question of inflationary adjustments or indexing for depreciation and other aspects of federal income tax accounting will not be dealt with in this article. In an era of rampant inflation, however, such adjustments may be critical to retain the essential fairness of any income tax system and to avoid confiscatory taxes on capital. The Brazilian experience in this regard is most instructive.

present law, the cost of a machine may not be treated as an expense in the year in which the machine is acquired because that is perceived as resulting in understating income for that year.

Generally our system has adopted the approach of allowing charge-offs over the useful life of an asset. The amount charged off is the product of three factors: the useful life, the depreciation method, and the salvage value. The method of accounting, whether mass asset or individual asset; the treatment of retirements, whether normal or abnormal; and other accounting conventions, such as half-year conventions, modified half-year conventions, and the like, are mere glosses on this central theme. Again, speaking theoretically, this basic approach has the virtue of simplicity. Indeed, this procedure is consistent with the developments in accounting theory and practice over the past four or five hundred years. It would doubtless require some temerity to recommend its abolition or rejection without a great deal of analysis.

Since the adoption of our income tax in 1913, the defects of our tax system's depreciation provisions have centered basically on their administration and ease of compliance. Commencing in 1913 and continuing until the adoption of guideline class lives in the early 1960's, the principal controversy concerning depreciation related to the selection of a useful life for depreciable assets. For any given taxpayer, the useful life of each asset depended on the particular "facts and circumstances." Throughout this period, taxpayers took aggressive positions without any objective guidelines. The Internal Revenue Service took an equally aggressive position in its own behalf; and the courts were clogged with factual controversies. There was no assurance that similarly situated taxpayers could achieve any consistency in results.

Because of disenchantment with the use of the "facts and circumstances" test, in the early 1960's the Treasury attempted to cut the Gordian knot of the useful life controversy by a two-pronged approach. First, it adopted guideline lives for machinery and equipment, based upon certain surveys conducted by the Treasury Department. This is the precursor of the current ADR system. Taxpayers were encouraged to adopt these guideline lives. But to do so, they had to comply with the second prong, compliance with a so-called reserve ratio test.[6] In theory, the reserve ratio test was a very simple one. It operated on the proposition that if all assets of a particular type are grouped in one account (a mass asset account), the accumulated depreciation reserve should constitute a particular percentage of the historical undepreciated acquisition cost of the assets in that particular account after one life

[6] Rev. Proc. 62-21, 1962-2 C.B. 418.

cycle of assets has been completed if the taxpayer's replacement and retirement experience is consistent with the useful life adopted.

For example, assume that a taxpayer buys one machine a year, on January 1, at a cost of $2,000 and claims a two-year useful life and straight-line depreciation. If each machine is retired on January 1, two years after acquisition, after one life cycle, on December 31 of any year, he will own two machines, one fully depreciated and the other one-half depreciated. In other words, the reserve ratio test would indicate that the depreciation reserve should be 75 per cent of the asset cost under straight-line depreciation and no growth where the taxpayer owns only two machines. If, on the other hand, the machines really last three years and the taxpayer can operate three machines after one life cycle, on any given December 31, he will own two fully depreciated machines and one machine that will be one-half depreciated, giving him a reserve ratio of 83⅓ per cent. Alternatively, if the taxpayer delays purchasing a third machine and only operates two at any given time, after one life cycle he will own two fully depreciated machines and will flunk the test.

Thus the reserve ratio test was a test of whether the taxpayer's retirement and replacement experience had been consistent with the useful life adopted for depreciation. If the retirements and replacements took place much later than the useful life adopted in computing depreciation, the depreciation reserve for the asset class was built up above the maximum permissible limit for the method of depreciation adopted. When the taxpayer's reserve exceeded that permissible limit, he flunked the test, and an adjustment of the useful lives was in order.

Throughout the 10-year period after its adoption, the reserve ratio test (but not the more liberal guideline lives) was the target of a steady drumfire. Numerous attacks were made on the grounds that the complicated compliance computations were cumbersome at best; that the transitional rules were incomprehensible; that it was difficult or unfair, for example, to apply mass asset tests that were more readily applicable to telephone poles of a utility company than to machinery of a small manufacturing plant; and that retirements did not always correspond to the traditional statistical normal bell curve.[7] By the early 1970's, the proponents of the reserve ratio system were in disarray. In addition, in response in part to the continual clamor since the 1940's for faster depreciation as partial compensation for inflation, the more liberal

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[7] For a good discussion of the problems with the reserve ratio test, *see* Comment, *The Asset Depreciation Range (ADR) System: Inequity in the Revenue Act of 1971,* 13 B. C. IND. & COM. L. REV. 870 (1972); Feinschreiber, *Depreciation Reform: Recent Treasury Study Reveals Liberalization Alternatives,* 33 J. TAX. 204 (1970); Worthy, *The ADR Depreciation Regulations,* 2 TAX ADVISOR 267 (1971).

aspect of Revenue Procedure 61-21[8] was retained, namely, guideline lives, and the reserve ratio was discarded.

The current elective ADR system, adopted in 1971, was intended to improve the liberal guideline life system without adopting the difficulties inherent in the reserve ratio test. It has the merit of utilizing guideline lives, based on surveys of various industries, that are updated by the Office of Industrial Economics of the Treasury Department. A close look at the ADR provisions indicates that although it may have been an "improvement," it nevertheless created additional complexity in the Internal Revenue Code. The rules of the ADR system can be succinctly summarized as follows:

(1) Machinery and equipment placed in service after December 31, 1970, may be depreciated over useful lives selected from a range of years 20 per cent below to 20 per cent above the guideline lives established by the Treasury in 1961. The useful lives may be amended from time to time.[9]

(2) Taxpayers may adopt a new, modified half-year convention. Property placed in service during the first half of the taxable year is treated as placed in service at the beginning of the year and property placed in service during the second half of the year is treated as placed in service on the first day of the succeeding taxable year.[10]

(3) The salvage value estimated by the taxpayer at the time the account is established generally will not be changed by the Internal Revenue Service unless, given the facts and circumstances at that time, an adjustment of more than 10 per cent of the cost of the assets in the account is required.

(4) A certain percentage of repair, rehabilitation, and maintenance expenditures for each guideline class may be deducted currently, and any expenditures over that amount are capitalized and recovered through depreciation if the taxpayer so elects. Expenditures that are clearly capital in nature must be capitalized and recovered through depreciation in all events.[11]

(5) The use of closed-end vintage accounts is required in the ADR system. Taxpayers are required to file annual schedules with their tax

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[8] 1962-2 C.B. 418.

[9] One of the major flaws of the ADR system is that it does not apply to real estate and intangibles, which are still under the facts and circumstances test.

[10] A half-year convention permitting all property placed in service in a given taxable year to be considered placed in service in the middle of the year is also available. *See* Treas. Reg. § 1.167(a)-11(c)(2)(iii).

[11] There is a *de minimis* rule for capital expenditures of $100 or less, which is considered to be tantamount to current expenses and therefore deductible immediately. *See* Treas. Reg. § 1.167(a)-11(d)(2)(vi)(g).

returns that provide information on asset acquisitions and asset retirements by vintage accounts, showing the amount, type, and age of assets retired. Also additional information pertaining to the experience with respect to the repair, maintenance, rehabilitation, or improvement of assets in each guideline class is required.

The ADR rules have added complexity to an already complicated depreciation system. These rules are applied in conjunction with the various depreciation methods. The straight-line method and the accelerated methods of depreciation—declining-balance method, double-declining-balance method, sum-of-the-years'-digits method, and combinations of the above—produce a myriad number of different methods, as well as different amounts of deductions for similarly situated assets. The complexity is compounded further by the recapture provisions of the Internal Revenue Code, that is, Sections 1245, 1250, 1251, 1252, and 1254, as well as the dichotomy between repair expenses that are deductible currently and capitalized expenditures that are subject to depreciation. Another related area, the investment tax credit, further complicates the selection of a useful life for depreciation purposes, since the useful life selected must be the same for both purposes, with a longer life (up to eight years) resulting in a greater investment tax credit but correspondingly reducing the annual depreciation.

The underlying tax policy of depreciation seems to combine a historic desire to compute depreciation in order to reflect income accurately with the more recent desire to spur industrial investment. The combination is quite evident in the ADR rules adopted in 1971. Since the policy still reflects a combination of these two desires, the obvious solution is to simplify ADR. Indeed, President Carter has recently proposed such a simplification plan, which includes the following elements:

(1) Elimination of salvage value. This is a sound simplification, since it will make ADR easier to use.

(2) Elimination of some reporting requirements, which, based on the impromptu survey mentioned above, will encourage more taxpayers to use ADR.

(3) Elimination of the sum-of-the-years'-digits method. The reduction of the permissible methods, leaving only the straight-line and declining-balance methods, obviously simplifies and does not seem to impinge upon the underlying tax policy.

In addition to these proposals, at least one, and possibly two, additional simplification proposals should be considered. The first would be to make ADR mandatory, and thus eliminate disparate taxpayer

treatment. Although this may first appear as a taxpayer equity argument, it is clearly consistent with underlying policy and is also a simplification in that it should eliminate most, if not all, disputes about useful lives and salvage value that are present in the facts and circumstances test.

Second, consideration should be given to reducing the number of guideline lives by creating a smaller but broader number of categories of useful lives. This could be done without much, if any, violation to the policy behind depreciation and should ultimately result in even more simplified reporting.

A number of other proposals could be made in the name of simplification, but under analysis these appear to conflict with existing tax policy. One proposal, which has been espoused for over 20 years,[12] would allow an immediate write-off of purchased investments, coupled with the repeal of the investment tax credit. The primary argument in favor of allowing immediate expensing is the simplicity of this procedure, compared with the complex rules that currently exist, as discussed above.[13] The proposal would be consistent with present socioeconomic policy based on two arguments. First, corporations making investments would incur fewer taxes than firms not investing, which would increase current investments and directly stimulate the economy. Second, such a proposal would not only greatly simplify the law but also would reduce the present cost of compliance incurred by industry and the government.

One economic analysis of this proposal indicates that the cost effect to the government and the benefits derived by a taxpayer are comparable to the present costs and benefits realized by these parties under accelerated depreciation and the investment tax credit for short-lived assets.[14] It is obvious, of course, that the government would initially lose significant revenue from this kind of proposal. Indeed, it is believed that such a proposal essentially creates a tax-free world for taxpayers. This analysis goes as follows: If a taxpayer is willing to spend $1, after tax and before depreciation for equipment that will generate $.20 annual taxable income, he will, under a full write-off system, be willing to spend $2 and generate $.40. At a 50 per cent tax rate, he has only spent $1 after tax and has generated $.20 after tax and increased his after-tax return by 100 per cent. Although those who subscribe to this analysis generally accept the fact that revenue to the government would be greatly in-

[12] *See* Dean, *Four Ways To Write Off Capital Investment: Management Should Have A Wider Tax Choice*, 29 J. Bus. 79 (1956).

[13] *See* Bierman, *A Case for Immediate Expensing of Equipment for Tax Purposes*, 144 J. Accountancy 87 (Oct. 1977).

[14] *See id.* at 88-89.

creased over the long term, they argue that if taxpayers behave this way, the increase would come as a result of, in effect, a capital contribution by the government of $1 to the hypothetical taxpayer.

Regardless of the merits of these various arguments, which admittedly are merely summarized and not analyzed herein, it is clear that this proposal is at odds with the part of the tax policy that is designed to match income and expenses. In short, any balance between the matching objective and investment stimulation objective is destroyed. This is also true of any approach that seeks to provide a very small number of useful life categories, all of which are quite short.

Another proposal that is not as extreme as the immediate expensing of capital expenditures would be to provide for different depreciation treatment between large and small companies. This proposal may appear, at first blush, to be inequitable, since taxpayers would be treated differently based on their size; but it can be argued that this proposal merely recognizes what is presently the practice in the business community. As indicated above, most large companies use the ADR system, avail themselves of the investment tax credit, and strictly comply with the recapture provisions. On the other hand, smaller companies generally avoid the use of the ADR system because of its apparent complexity and, therefore, adopt aggressive positions pertaining to useful lives based on the facts and circumstances test. Although the adoption of these useful lives may cause smaller companies to forsake some benefits under the ADR system, these lost benefits apparently are frequently recovered when the assets are sold and recapture is not reported.

Under this proposal, certain large companies, determined solely by size, would be required to adopt conforming methods of depreciation, for example, the straight-line method or the declining-balance method or both, and to adopt similar useful lives for related assets, for example, the ADR system, as other comparable companies. This would enable the government to audit these depreciation adjustments more efficiently and with more consistency. Obviously, there may be some complexity involved in drafting a definition that distinguishes between large and small companies and that provides for transitional rules as a company moves from one category to another. Whether the resulting definitional complexity is worth the simplicity is problematical.

Assuming this problem could be solved, the smaller companies might be subject to a new guideline useful life approach: a two-tier system under which there would be a fixed short number of years over which machinery and equipment would be written off and a fixed but longer number of years over which buildings would be written off. Although

these guideline useful lives would probably deviate from the actual life of each individual asset more than is presently the case under the ADR system, and would therefore result in a possible unclear reflection of income, this proposal, nevertheless, would probably simplify the tax laws. A new depreciation method could also be adopted for smaller companies, in lieu of the present methods. Thus, for example, depreciation could be allowable over the useful life of each asset (machinery, equipment, and buildings) in the year of purchase up to 40 per cent of its cost, at the election of the taxpayer, with the balance of the depreciation for each asset being allowable as a deduction in subsequent years, at the election of the taxpayer.[15] Depreciation recapture would still be applicable in present form for all companies, as well as the current investment tax credit rules.

This proposal may be criticized on two grounds. First, it substitutes one complexity, small business definition, for the perceived complexity of our current depreciation rules. This is a trade-off that seems unrewarding when one considers the ramifications of the new complexity. Second, even assuming a workable definition, what happens when a small business becomes a large business (either by growth or by acquisition) or when a formerly large business becomes a small business (for example, by spin-off or by business decline)? The analysis of the proper answer, if there is one, to these questions is beyond the scope of this paper. This, in itself, seems to reaffirm the fact that the sensible way to deal with depreciation complexities is to deal with them directly and not to solve them by trying to delineate groups of businesses that fall within the parameters of different rules.

INVESTMENT TAX CREDIT

The investment tax credit was generated when Congress decided that the economy needed a boost in the form of an incentive for capital investment.[16] The present credit is based on a percentage of the cost of

[15] *See, e.g.*, H.R. 7543, 94th Cong., 1st Sess. (1975), which provides that at the taxpayer's election, Section 1245 property would be depreciable over a five-year useful life: 40 per cent in the first year, 24 per cent in the second year, 18 per cent in the third year, 12 per cent in the fourth year, and 6 per cent in the fifth year. Section 1250 property would use a 10-year useful life and would be depreciable in the following amounts: 20 per cent in the first year, 16 per cent in the second year, 14 per cent in the third year, 13 per cent in the fourth year, 11 per cent in the fifth year, 9 per cent in the sixth year, 7 per cent in the seventh year, 5 per cent in the eighth year, 3 per cent in the ninth year, and 2 per cent in the tenth year.

[16] *See, e.g.*, S. Rep. No. 1881, 87th Cong., 2d Sess. 11 (1962), where it was stated:

> The objective of the investment credit is to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country, with a resultant increase in job opportunities and betterment of our

the acquisition of capital business goods and certain manufacturing facilities and is allowed as a credit against the purchaser's tax liability. Any excess may be carried back three taxable years and then carried forward seven taxable years. The maximum credit allowance is 10 per cent for property with a useful life of seven years or more. The percentage decreases to zero for property with a useful life of less than three years. The credit is limited with respect to the purchase of used equipment for the first $100,000 of used equipment purchased in any given year. Investment tax credits may be used to offset all of the first $25,000 of tax liability but no more than 50 per cent of the remainder. When the taxpayer disposes of the property for which there has been an allowable tax credit before the end of its useful life, recapture of the credit applies on all or a portion of the credit originally taken.

The investment tax credit is nonrefundable and is subject to complex rules pertaining to carryback, carryforward, and recapture. The obvious simplification is to make the credit refundable, as is the case with credits used to refund overpayments of taxes other than income taxes.[17] The taxpayer would therefore get an immediate refund for his investments, rather than be subject to the present carryover provisions and the resulting possibility that some of the credit may be lost. This would greatly simplify the law for companies with large losses and for other companies unable to use the credit, some of which are accordingly compelled to turn to complex leasing transactions.[18] Presumably, refundability would permit the elimination of many of the leasing provisions in the current statutes or, at least, permit their elimination for most taxpayers.[19] More-

competitive position in the world economy. . . . It is your committee's intent that the financial assistance represented by the credit should itself be used for new investment, thereby further advancing the economy.

In addition, the investment tax credit was adopted because economists recognized that the very nature of an income tax served as a disincentive to a capital investment. This is but a variation of the old public finance theory that an income tax is a double tax on investment—representing first a tax on the income generated to make the investment and second on the income from the investment.

[17] Current examples of refundable credits include the overpayment of an employee's social security taxes (Section 31(b)) and the overpayment of excise taxes on gasoline and other fuel that has been used for an exempt purpose (or for off-highway purposes, with respect to which the special fuel tax applies at a reduced rate).

[18] Similarly, Section 46(e)(1) currently deprives cooperatives and their members of the investment tax credit based on the percentage of taxable income distributed as patronage dividends. This forces cooperatives to turn to leasing transactions without any substantive justification.

[19] A refundable credit has the appearance of a direct subsidy, and this leads to the argument that the basis of the purchased assets should be reduced by the amount of the credit. The comparable argument is that the credit is really similar to a contribution to capital by a nonshareholder (the government) and that Section 362(c) rules should apply. Indeed, in its original enactment, the investment tax credit statute provided that tax basis was to be reduced by the amount of the credit, but Congress, in 1964, abandoned the basis reduction provisions. Solely in terms of simplification, it would

over, this simplification seems quite consistent with the underlying rationale behind the credit: to spur industrial investment. Indeed, Senators Kennedy and Long, acknowledging that they are seldom found marching to the same drummer," called for refundability of the credit on August 12, 1977, on capital formation grounds, stating they believe that it would be "an important capital incentive." [20]

Another problem inherent in the current investment tax credit rules that is ripe for simplification is that the credit applies only to certain types of depreciable property and does not apply to buildings and their structural components. This distinction has frequently caused controversies concerning the definition of a building and its components. It

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seem that basis reduction does not simplify the Internal Revenue Code, as it requires complicated drafting to face the problem of early disposition, resulting in recapture of credit and additional taxable income, which results in a double penalty. In fact, apart from tax logic purity, a case for basis reduction seems more a quarrel with the amount of the credit than anything else. In this connection, the legislative history regarding the elimination of the basis reduction provisions in 1964 indicates that Congress thought that the basis reduction provision was both complicating and counter to the incentive policy behind the credit. Thus the REPORT OF THE WAYS AND MEANS COMMITTEE states as follows:

> Although the investment credit enacted last year appears to have been successful in stimulating investment, several problems have arisen with respect to this credit which are dealt with in this bill.
>
> First and most important of the changes made is the repeal of the requirement that the basis of property eligible for the investment credit be reduced by 7 per cent of the qualified investment. This provision requires that if property costing $100 and eligible for an investment credit of $7 was acquired, the basis of this property for purposes of depreciation (or gain or loss on sale) was to be reduced from $100 to $93.
>
> This provision has proved troublesome to taxpayers since it requires a downward basis adjustment with respect to eligible property whether or not an investment credit is claimed for the property. Moreover, making this adjustment has presented recordkeeping problems for taxpayers, and also severely complicated the statutory language of the investment credit provision.
>
> In addition, this basis adjustment for property severely restricted the incentive effect of the investment credit. In effect, this amendment converted the 7-percent credit into a 3½-percent credit for corporations, plus a 7-percent initial depreciation allowance. This result occurs because the decrease in basis of the asset which may be written off means that the equivalent of approximately one-half of the investment credit is recouped over the life of the asset in substantially the same manner as an initial depreciation allowance. This effect substantially reduces the incentive effect of the credit, since it means that approximately half of the benefits must be restored over the useful life of the asset. In effect, this transforms one-half of the credit into an interest-free loan.
>
> To remove the recordkeeping and accounting problems which have arisen in connection with the basis adjustment provision and also to provide a greater stimulus with respect to the investment credit, your committee's bill repeals this basis adjustment provision with respect to property placed in service after June 30, 1963. It also provides a means whereby over a period of time taxpayers may recoup their basis adjustments already made. The repeal of this provision restores the investment credit to the position taken by the House in 1962 with respect to this credit. H.R. REP. No. 749, 88th Cong., 1st Sess. 34 (1963).

[20] 158 BNA DAILY TAX REPORT J-1 (August 15, 1977).

follows that if the investment tax credit is desired to promote investments in long-lived assets, particularly manufacturing assets, one could argue, with a great deal of force, that the investment tax credit should certainly be applied to the building structure of manufacturing facilities. This would not only eliminate a great deal of controversy but would also meet the objective of promoting capital investment.[21]

An additional simplification that might be considered is to eliminate the advance determination of a useful life in determining the percentage of credit. Under this suggestion, the full credit would be granted on all purchases of qualified equipment, and the useful life percentage reduction would be effected by recapturing the appropriate percentage, with interest at the statutory rate, at the time the assets are disposed of or scrapped, if the disposition or scrapping takes place before the eighth year.

Even assuming that the recordkeeping required to implement this proposal would not in and of itself be a complexity, the proposal may appear to be counter to one of the underlying policies of the credit, that is, it was designed more to encourage investment in longer-lived assets than in shorter-lived assets. Indeed, as originally proposed by President Kennedy in 1961, the credit was to have been available only to assets with a useful life of six years or more because:

> The exclusion of certain short-lived assets follows the precedent established under the liberalized depreciation rules and the additional first-year depreciation allowance for small business. The short-lived assets represent an area of investment in which assets are turned over rapidly and investment risks are typically less.[22]

Congress, however, modified the Kennedy proposal and, thus, the Kennedy rationale and permitted a reduced credit for shorter-lived assets. The asserted justification for the reduction was that it was necessary to avoid creating a bias in favor of short-lived assets because of their turnover. Thus the *Report of the Ways and Means Committee* states as follows:

> In your committee's consideration of the investment credit last year it was planned to make the credit available only with respect to assets with a life of 6 years or over. However, its review this year has convinced your committee that the credit should be made available

[21] Indeed, the Carter proposals expanded the credit to include industrial buildings specifically in order not only to encourage business to carry out "more balanced investment programs" but also to eliminate many disputes over whether something is equipment on a building or a structural component thereof. Fact Sheet 31.

[22] Statement of Secretary of the Treasury Dillon, H.R. Doc. No. 140, 87th Cong., 1st Sess. 47 (1961).

> at least in part for shorter lived assets. There is a substantial volume of industrial equipment with lives of 4 and 5 years, investment in which should also be encouraged. At the same time your committee recognized that, with the more rapid turnover of short-lived assets, the plan as considered last year would have provided a substantially greater investment credit for short-lived assets than for longer lived assets. For example, in the case of a $1,000 investment in a 4-year asset, which is replaced as it wears out, three $80 credits could be obtained in the same time span in which one $80 credit could be obtained in the case of a $1,000 investment in a 12-year asset. As a result of these factors, your committee has provided that assets with lives of from 4 up to 6 years are to be taken into account in determining the allowable credit on the basis of one-third of the investment made; those with lives of from 6 up to 8 years are to be taken into account on the basis of two-thirds of the investment made; and only those with expected lives of 8 years and over will be taken into account on the basis of the full investment for purposes of the credit.[23]

Since many assets may well be used for a longer period than the useful life assigned for tax purposes, granting a full credit with recapture only on disposition is counter to the "risk" rationale suggested by Dillon but is not counter to the turnover rationale stated by the Ways and Means Committee. It is quite possible, however, that the lesser credit with quicker cost recovery through depreciation serves the ultimate investment incentive rationale, and any attempt to extend the full credit to short-lived assets merely creates an unwarranted bias for investments in those assets. Assuming that the incentive policy of the credit is independent from, and in addition to, any policies underlying depreciation, however, it seems clear that Congress has said that investment in both short- and long-lived assets is to be encouraged, and the proposal to permit full credit with recapture rules on disposition is a simplification consistent with that policy. The writer fully recognizes the risk that marginal companies on the brink of insolvency might be tempted to acquire short-lived property in order to receive the full credit and that if those taxpayers thereafter become insolvent prior to the time that the recapture event occurs, the Treasury, in effect, has extended them short-term credit and has become an unsecured claimant. Nevertheless, this risk seems well worth taking in order to encourage marginal companies to engage in capital formation, since it is with these companies that the current investment tax credit has been a dismal failure.

With respect to recapture, regardless of whether a full credit with

[23] H.R. REP. No. 1447, 87th Cong., 2d Sess. 9 (1962).

recapture only on disposition is adopted, by analogy to the bulk sale rule for inventory in Code Section 337, consideration should be given to eliminating the requirement of recapture in a case where all the operating assets of a business are sold intact and the purchaser continues to operate them as a unit. Current law requires recapture when the seller has engaged in a taxable disposition and the purchaser acquires a purchase price basis for the assets acquired but waives recapture for tax-free dispositions when there is a carryover basis. When the assets continue to be operated in the same manner, the credit has fulfilled its purpose of stimulating investment, and the purchaser's tax basis should not be relevant for this purpose.[24] A waiver of recapture in the event of a taxable disposition would, of course, require a carryyover of the holding period to the purchaser for the limited purpose of computing recapture and blocking the device of a taxable sale followed by a scrapping of the assets by the purchaser solely to avoid recapture.

An argument can also be made that recapture should not be imposed even for individual assets when the purchaser does not scrap them, but this might require some complexity. Thus, as a first step, probably only an "entire business" exception should be adopted.

CAPITALIZED VERSUS DEDUCTIBLE EXPENDITURES

Repairs

The classification of a repair as a current expense or a capital item has resulted in confusion and protracted litigation on many occasions. A classic example of this complexity is found in the ADR regulations, where detailed rules distinguish between the treatment for current repair expenses and those for capital expenditures, although noting that an expense and a capital expenditure have very similar characteristics. In general, expenditures that substantially prolong the life of an asset or are made to increase its value or adapt it to a different use are capital expenditures. If an expenditure is treated as a capital expenditure, it is subject to the allowance for depreciation; if not, it may be deducted as an expense in the taxable year in which it is paid or incurred. This all-or-nothing approach, coupled with the complexity in the statute and the regulations, has caused some taxpayers to be extremely aggressive in claiming that an item should be expensed currently. As a corollary to this reporting position, this issue is frequently raised in corporate audits and generally consumes an inordinate amount of time and effort in resolving the differences between the government and the taxpayer.

[24] *Cf.* note 19, *supra.*

One proposal that seems to remedy this problem would be the total write-off-expense method, described above. Alternatively, perhaps the adoption of a two- or three-tier useful life system for purposes of depreciation would have the effect of decreasing the impetus to expense items currently, since, with greater simplification, more taxpayers might adopt a position free of doubt and ambiguity, rather than incur the expense of controversy. Absent these radical approaches to depreciation, however, the repair-capital expenditure problem seems likely to remain a problem that can only be solved at audit. Perhaps the audit can be simplified by increasing the present *de minimis* capital expenditure rule from $100 to $1,000 and thereby reduce the number of determinations that would have to be made concerning what items are capital expenditures, as opposed to current expenses.

Pre-Opening or Start-Up Costs

The current treatment of certain expenditures, such as pre-opening expenses and the costs of developing new products, has created added complexity and controversy in the tax system. In the past 10 years, numerous courts have been forced to address the issue of whether pre-opening expenses, that is, expenses incurred before a business opens its doors to its customers, are deductible. The Internal Revenue Service usually takes the position that the expenses must be capitalized and cannot be depreciated if there is no readily determinable useful life. Similarly, the Internal Revenue Service has taken the position that costs of developing new products or even new customers (costs that are not research and development expenses in a traditional laboratory sense) again must be capitalized and cannot be depreciated because there is no readily determinable useful life.

A system that breeds substantial controversy regarding the treatment of pre-opening and business development expenses is neither simple nor desirable. First, compliance is difficult on the part of all concerned. Second, businesses that evolve and change in response to changes in consumer tastes, in technology, and in the economy are placed at a disadvantage, compared with those businesses that incur traditional research and development expenses that are deductible. This entire area could be simplified and the controversy greatly reduced by adopting a compromise akin to that adopted for corporate organizational expenses. There, the law prescribes a 60-month fixed amortization. Adoption of

a similar statutory standard for these types of expenses could have salutary effects for simplicity.[25]

PREPAID EXPENSES

The rules concerning prepaid expenses are not significantly complex. The rules are straightforward and depend on whether the taxpayer is on the cash receipts and disbursement method of accounting or the accrual method of accounting.

Under the cash receipts and disbursement method of accounting, expenses are deductible when paid, subject to the caveat that income must be clearly reflected on a current basis. For example, prepaid interest is deductible when paid, except with regard to advance payments that exceed interest attributable to the taxable year in which the prepayment is made. Any excess is charged to a capital account and is treated as paid in the period to which it is allocable. This rule is consistent with the joint tax doctrines of preventing a distortion of a taxpayer's income and adding certainty to the treatment of such expenses. Accrual basis taxpayers can deduct expenses for the taxable year in which all the events have occurred that determine the fact of the liability when the amount thereof can be determined with reasonable accuracy. Most corporations are on the accrual basis of accounting, since it is required when inventories are used in their businesses. Although the present rules are easy to apply in practice, some complexity is nevertheless apparent, since an initial determination must be made of whether an item is an expense or a capital expenditure. Once this determination has been made, the tax treatment is clear. All of the persons canvassed reported that they had no problem in understanding or dealing with prepaid expense rules and that controversies were few and far between and easily settled.

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[25] One might argue that taxpayers will still claim immediate deductibility of these expenses, and thus controversies will still arise. By eliminating the all-or-nothing stake, however, the necessity for carrying the controversy to conclusion is greatly reduced and one would expect in the long run that most of the controversies would be easily settled.

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Integration of Individual and Corporate Income Taxes

Alvin C. Warren, Jr.

THE PROBLEM: OVER AND UNDERTAXATION OF INCOME FROM CORPORATE ASSETS

If individual shareholders are regarded as ultimately bearing the federal income tax levied on corporate income,[1] then corporate income distributed in the form of dividends is taxed more heavily than other kinds of individual income. Earnings are taxed once at the corporate level and then again when received by individual shareholders. Thus $100 of corporate income is reduced to $50 by a 50 per cent corporate income tax and further reduced to $15 when distributed to a 70 per cent shareholder or to $40 when distributed to a 20 per cent shareholder. Although both shareholders end up with less than they would have received if the $100 had been earned by them individually ($30 and $80 respectively), it is the lower bracket shareholder who pays the greater additional tax as a result of the separate tax on corporate income. Taxes on account of his distribution are increased from 20 per cent to 60 per cent, while the comparable increase for the 70 per cent shareholder is from 70 per cent to 85 per cent.

This "overtaxation" of distributed earnings, described in the last paragraph, is unfair if equality of treatment for different types of individual income is taken as the relevant touchstone of tax equity. The premise of the overtaxation conclusion is that only individuals have taxable capacity and that fairness among individuals in taxation requires

* Alvin C. Warren is a Professor of Law at the University of Pennsylvania Law School, Philadelphia, Pennsylvania.

[1] The actual incidence of the corporate income tax is much disputed, both as a theoretical and as an empirical matter. The tax is sometimes said to be shifted to owners of capital generally and to consumers or workers or both. *See generally* EFFECTS OF CORPORATION INCOME TAX (M. Krzyzaniak ed. 1966); Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POLITICAL ECON. 215 (1962); Shoven, *The Incidence and Efficiency Effects of Taxes on Income from Capital,* 84 J. POLITICAL ECON. 1261 (1976); Stiglitz, *The Corporation Tax,* 5 J. PUB. ECON. 303 (1976); Stiglitz, *Taxation, Corporate Financial Policy and the Cost of Capital,* 2 J. PUB. ECON. 1 (1973).

the equal taxation of income, regardless of its source, that flows to an individual. This premise also leads to a finding of undertaxation of retained earnings when the corporate tax rate is lower than the individual tax rate and when the application of the shareholder tax can be deferred for a long enough period, particularly if the ultimate distribution is subject to capital gains treatment.

In addition, over and undertaxation of income from corporate assets may have deleterious economic effects to the extent that the differential taxation of corporate income is thought to reduce savings and investment in general; to discourage investment in corporate securities in particular; to encourage retention, rather than distribution, of corporate earnings; and to encourage corporate financing by debt, rather than equity, instruments.[2]

Recent political interest in the integration of individual and corporate income taxes has sprung from a desire to ameliorate the foregoing inequities and the economic distortions that are perceived to result from over and undertaxation of corporate income.[3] Unfortunately, for a conference dedicated to simplification, each of the policy choices that is likely to be attractive as a means of achieving that amelioration involves some increment in complexity. This paper, which cannot possibly analyze all of the multitudinous policy issues raised by integration, sets forth the basic theory of full and partial integration and discusses the principal structural issues that will affect the simplicity of the tax law.

THE THEORETICALLY CORRECT SOLUTION: FULL INTEGRATION

The Proposal

Implicit in the definition of the problem set forth above is the theoretically correct solution. If the defect of the current tax law is its failure to tax corporate income at the individual shareholder's marginal rate, then the solution is simply to attribute retained earnings to each shareholder and to apply only the shareholders' rates to those earnings, as well

[2] There may also be some economic distortion caused by the availability of full integration for closely held enterprises under Subchapter S, as well as under the provisions applicable to partnerships and proprietorships. Whether any of the alleged deleterious effects on economic efficiency are likely as a matter of fact is subject to dispute. *See, e.g.*, the Stiglitz articles, *supra* note 1.

[3] *See generally* McClure & Surrey, *Integration of Corporation and Individual Income Taxes: Some Issues for Corporate Managers and Other Groups*, 55 Harv. Bus. Rev. 169 (1977); McClure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 Harv. L. Rev. 532 (1975).

as to dividends. In short, the corporation would become a conduit, rather than a separate entity, for tax purposes. If any tax were continued at the corporate level, it would be a mere withholding tax for which shareholders would receive full credit on distribution or attribution of earnings. The closest models for this kind of conduit treatment under current law are the federal taxation of partnerships and Subchapter S corporations, although those provisions involve neither the largest aggregations of capital nor withholding taxes.

The Ford Administration Treasury Department's *Blueprints for Basic Tax Reform* (1977) included a proposal for full integration that called for attribution of corporate earnings (or losses) at year-end to the shareholders of record on the first day of the corporation's taxable year, along with a corresponding increase (or decrease) in shareholder basis. Distributions of earnings would reduce basis, but would not be taxed unless basis had already been reduced to zero.

Simplification Aspects of Full Integration

Adoption of full integration would permit elimination of the following complex parts of the Internal Revenue Code: the accumulated earnings tax, the personal holding company provisions, the dividend-received exclusion, the rules that divide corporate distributions between dividends and capital gains, the rules that distinguish dividends from returns of capital (if the earnings and profits concept were foregone), the nonrecognition of gain on liquidation-related sales of assets, the Subchapter S corporation provisions, the multiple surtax exemption provisions, and, if applied without exception, perhaps the provisions granting special treatment to particular industries.

More significantly, since adoption of integration would, in effect, tax retained corporate earnings as ordinary income when earned, rather than as capital gains when corporate stock is sold, it would arguably facilitate repeal of the special tax treatment of capital gains and losses, a giant step for simplification. To the extent special tax preferences, such as the investment tax credit and accelerated depreciation, have been enacted, in part, to mitigate the overtaxation of income from corporate assets, full integration might stimulate their repeal and produce the resulting simplification.

To be weighed against the foregoing simplification benefits are the following new problems that would be created by full integration. Many of these new problems would undoubtedly involve new complexities in their solution.

(1) *Attribution and Liquidity.* Some means would have to be devised to attribute the appropriate amount of retained earnings among the holders of a great variety of capital shares (such as common stock, preferred stock, participating preferred stock, convertible debentures, and so on). If attribution were simply left to corporate managers, there might be pressure for reduction of the variety of available capital interests, which, arguably, would reduce the efficiency of the capital markets. Attribution would also require frequent basis adjustments and the attendant additional complexity.

If withholding at the source were desired as an aid to collection and to avoiding problems of shareholder liquidity, then a withholding rate would have to be set and a mechanism developed for exemption or refund to low-income shareholders.

(2) *Tax Shelters.* If losses, as well as gains, were fully passed through to individual shareholders, the corporation would become an attractive vehicle for tax shelter operations, as have partnerships in recent years, presumably requiring extension of existing anti-abuse provisions or creation of new ones.

(3) *Sales of Stock.* If corporate income were attributed to individual shareholders, an appropriate basis mechanism would be required to assure that a shareholder selling between attribution dates was taxed on his share of the income from corporate assets.

(4) *Corporate Preferences.* A decision would be required concerning whether the special tax character of items of corporate income, deduction, and credit (such as the exemption for interest on municipal bonds, accelerated depreciation, the investment tax credit, and so on) would be passed through to shareholders. An affirmative decision would require tracing rules to assure the proper pass-through. A negative decision would probably require new mechanisms to prevent pass-through completely.

(5) *International Considerations.* A decision would also be required concerning whether individual shareholders would receive the benefit of the corporation's credit for foreign taxes paid on corporate income and, if so, whether they could receive a refund if the credit exceeded their tax liability, even if the credited taxes had been paid to a foreign government. As in the case of corporate tax preferences, tracing rules or precautionary mechanisms might be necessary, depending on the answer. In addition, the existing limitation on the foreign tax credit might have to be restructured, since its application at the shareholder level would require complex calculations by individual taxpayers.

Yet another decision would have to be made about whether corporate income would be attributed to foreign shareholders in United States corporations and, if so, whether the United States would reach this income through a withholding tax. Finally, a decision would be necessary concerning whether income earned by foreign corporations would be "integrated" in any way with the individual income of United States shareholders. Whatever decisions were reached on these issues would likely affect treaty negotiations.

(6) *Tax-Exempt Organizations.* If a withholding tax were levied at the corporate level, a decision would be required concerning whether tax-exempt entities would be granted a refund for their portion of the withholding. An affirmative answer might imply a significant increase in the tax benefits to these entities, since their portfolio income is presumably presently reduced by the corporate income tax to the extent that tax-exempt organizations hold corporate securities. A negative answer might affect a mechanism designed to flow corporate tax benefits through to shareholders.

(7) *Audit Adjustments.* A decision would be required concerning the appropriate treatment of audit adjustments in regard to corporate income made years after the income had been distributed or attributed to individual shareholders who may no longer even hold stock in the corporation.

(8) *Multiple Corporations and Tax Attributes.* Full integration would have to be reconciled with the tax treatment of dividends paid by one corporation to another, with the existing provisions for tax-free changes of corporate form, and with the carryover or carryback of various tax attributes.

The first three of these eight potential areas of additional complexity relate to full integration alone, while the last five pertain as well to partial integration, which will be described in the next section. Accordingly, a discussion of potential solutions to each of these policy issues and the resulting complexity is deferred until the basic theory of partial integration is set forth.

RELIEF FOR DIVIDENDS ONLY: PARTIAL INTEGRATION

Introduction

"Partial integration" or "dividend relief" involves integration of the individual and corporate income taxes only with regard to distributed earnings. Its enactment may be supported by focusing on overtaxation of dividends as the problem (and ignoring undertaxation of retained

earnings), by a desire to avoid the need to attribute retained earnings to shareholders (a desire often said to rest on administrative considerations), or by revenue constraints. Relief for the double taxation of dividends can itself be either partial or full, so current jargon inelegantly divides partial integration into "full partial integration" (that is, full relief for the double taxation of dividends) and "partial partial integration" (that is, partial such relief), a usage that will be reluctantly followed in this paper.

Three methods of partial integration have been proposed: deduction by the corporation of dividends paid, reduction of the corporate tax rate on distributed earnings, and a shareholder credit and gross-up for corporate taxes paid on account of the distributed earnings. Each of these methods, which will be described in turn, applies the underlying policy of full integration—taxation of corporate earnings at shareholder marginal rates only—to distributed earnings. Other means of eliminating double taxation, such as a shareholder exclusion or credit without gross-up for dividends received, will not be discussed because they do not even purport to implement that policy. Repeal of the corporate income tax will also not be discussed because, although distributions would be taxed only at shareholder rates, retained earnings would not be subject to a current tax at either the shareholder or the corporate level.

Dividend Deduction Method

Full partial integration could be achieved by permitting corporate deduction of amounts paid as dividends, just as a deduction is now permitted for amounts paid as interest. The immediate effect of the deduction would be to increase the corporation's cash flow, although some of that benefit would probably be passed on to shareholders in the form of increased dividends. Since the dividend deduction method initially results in more cash at the corporate level, it is sometimes advocated as a superior form of partial integration on the ground that one of the purposes of integration is to provide additional incentives for capital formation. On the other hand, one of the method's defects is sometimes said to be its automatic extension of the benefits of integration to exempt and foreign shareholders, who would experience either greater share values or increased dividend payments along with taxable shareholders.

Partial partial integration could be achieved under this method by allowing a deduction for only some portion of actual dividend payments.

Split Rate Method

An alternative method of partial integration is to levy a corporate tax of a lesser rate on distributed earnings than is levied on retained earn-

ings. Full partial integration would require a tax rate of zero on distributions and would, in effect, be indistinguishable from a full dividend deduction. Partial partial integration would involve a tax rate on distributed earnings greater than zero but less than the rate for retained earnings, making it indistinguishable from an equivalent partial deduction for dividends. In addition, as will be shown below, the shareholder credit method can be described as a split rate (or dividend deduction) system with withholding. Thus since the split rate method is a variant or alternative description of the dividend deduction and shareholder credit mechanisms, it will not hereafter be discussed as a separate type of integration.

Shareholder Credit Method

This is the most commonly suggested method of partial integration and is the one used in European tax systems.[4] Integration is achieved by giving shareholders a tax credit for the corporate tax paid with regard to the distributed earnings so that the earnings are taxed at only the shareholders' rates. Since the federal income tax does not generally permit a deduction for federal taxes, the shareholder must "gross-up" his dividend by the amount of federal income tax paid by the corporation on account of the dividends he receives. A shareholder whose marginal tax rate is less than the corporate rate would presumably receive a refund if he had no other taxable income. Under this method, partial partial integration would simply involve a less than complete gross-up and credit by shareholders for taxes paid by the corporation.

Consider a corporation that receives $100 in taxable income and pays $50 in corporate taxes (assuming a 50 per cent corporate tax rate). The table below indicates how a $20 distribution would be treated by 50 per cent and 20 per cent shareholders:

	Distribution to a 50 Per Cent Shareholder	Distribution to a 20 Per Cent Shareholder
Cash distribution	$20	$20
Grossed-up dividend	40	40
Gross shareholder tax	20	8
Shareholder tax credit	20	20
Net shareholder tax	0	(12)

[4] The foreign experience is described in C. McCLURE, INTEGRATION OF THE PERSONAL AND CORPORATE INCOME TAXES (1978).

The grossed-up dividend is equal to the cash dividend (that is, the dividend net of corporate taxes) divided by 1–t, where t equals the corporate tax rate. Equivalently, the gross dividend equals the net dividend multiplied by 1/1–t, which equals 2 where the corporate tax rate is 50 per cent and 1.923 where it is 48 per cent. If all corporations are taxed at the same rate, a single gross-up rate can be used by all shareholders for all dividends from all corporations.

Unlike the dividend deduction, the shareholder credit leaves the additional cash flow in the hands of shareholders in the first instance. It is therefore arguably easier to prevent the benefits of integration from accruing to foreign and to tax-exempt shareholders by denying them the credit or a refund when they have no outstanding tax liability. Accordingly, former Secretary of the Treasury William Simon presented an integration plan to the House Ways and Means Committee in 1975 that was about half corporate deduction (to stimulate investment by increasing corporate cash flow) and half shareholder credit (to prevent foreign and tax-exempt shareholders and from gaining too much benefit).[5]

Nevertheless, it is important to note that the difference in cash flow assumes no change in the amount of cash dividends paid by corporations or in the incentives for shareholder reinvestment. To the extent that cash dividends would be reduced under the shareholder credit or increased under the dividend deduction, precisely the same results could obtain under either system. What method is deemed preferable thus depends, in part, on the effect of imperfections in the United States capital markets and on whether those imperfections suggest that it would be better to have the initial increase in cash flow at the shareholder or the corporate level.

The usual corporate tax rate might be considered too low, relative to shareholder tax rates, under partial integration either because of nominal rate differences between the corporate and individual schedules or because corporate preferences reduced the effective rate of corporate tax below the shareholder effective rates. As an administrative matter, it might be desirable to eliminate this discrepancy under the shareholder credit, either to permit full corporate withholding of taxes to be collected from shareholders or to permit a uniform rate of gross-up and credit. These goals can be accomplished by levying a "second-level" corporate or "withholding" tax on distributions.

Consider a normal (first-level) corporate income tax rate of 30 per cent, a maximum shareholder tax rate of 50 per cent, and a second-level

[5] Statement of William E. Simon, Secretary of the Treasury, before the House Ways and Means Committee (July 31, 1975).

corporate tax on distributions designed to assure that distributed income has borne a corporate rate of 50 per cent. The table below indicates how a distribution of $40 out of a corporate income of $100 before taxes would be treated.

	Distribution to a 50 Per Cent Shareholder	Distribution to a 20 Per Cent Shareholder
Corporate income	$100	$100
Normal (first-level) corporate tax	30	30
Available for distribution	70	70
Cash distribution	40	40
Additional (second-level) tax on distributions	10	10
Total corporate tax	40	40
Grossed-up dividend	80	80
Gross shareholder tax	40	16
Shareholder tax credit	40	40
Net shareholder tax	0	(24)

Such second-level taxes are common in the European integration systems. For example, under the United Kingdom statute, an amount equal to 35/65 of a dividend is paid by the corporation as an Advance Corporate Tax (ACT), which, in turn, can be used to reduce the corporation's usual or "mainstream" tax liability.[6] A United Kingdom shareholder grosses-up his dividend by the amount of the ACT and takes a credit in that amount against his tax liability. The ACT assures, in effect, that a minimum tax is paid by the corporation with respect to distributed earnings and is grossed-up and credited by the shareholder.

Equivalence of Partial Integration Methods

If it is thought desirable to have a withholding tax on dividends collected at the source under the dividend deduction method, that withholding tax will serve the same function as an equivalent rate corporate tax under the shareholder credit method (whether the equivalent rate is reached by a one- or two-level tax). The partial integration methods are equivalent to full withholding not only in their ultimate effect, assuming perfect capital markets, but also in their immediate result. Under the dividend deduction method, the shareholder must include

[6] Finance Act of 1976, § 26; Finance Act of 1972, § 84.

in income not only the cash dividends received but also the withholding tax collected from the corporation (just as in the case of withholding on salary)—precisely the same process as is involved in grossing-up the dividend under the shareholder credit mechanism. Likewise, the corporate tax on undistributed earnings plus the withholding tax on distributed earnings under the dividend deduction will equal the corporate tax due under the shareholder credit method. The table below illustrates this equivalence in the case of full partial integration where the corporate tax rate is 50 per cent, the withholding rate is 50 per cent, and a cash distribution of $25 is made to a 60 per cent shareholder by a corporation that has $100 in taxable income.

	Dividend Deduction	Shareholder Credit
Corporate taxable income		
(before dividend deduction)	$100	$100
Cash distribution	25	25
Corporate tax		
On taxable income (after		
dividend deduction)	25 [a]	50
On withholding on distribution	25 [b]	0
Total	50	50
Retained corporate earnings		
(after taxes)	25	25
Taxable dividend to shareholder	50 [c]	50 [d]
Shareholder tax	30	30
Shareholder credit		
(or withholding)	25	25
Shareholder tax due	5	5

[a] 50 per cent corporate tax rate applied to taxable income of $100 reduced by gross dividend of $50 (including $25 withholding tax).
[b] 50 per cent of gross distribution of $50.
[c] $25 cash dividend plus $25 withholding.
[d] $25 × 2 = $50.

Equivalence with Full Integration

If the maximum individual tax rate is reduced to equal the corporate tax rate, and if capital gains are taxed as ordinary income, proposals that are said to be on the agenda of the Carter Administration, full partial integration may also be equivalent to full integration. Although shareholder taxation of corporate earnings (at ordinary income rates) will still be deferred until distribution, the benefit of that deferral will be offset by the corporate tax, which is equivalent to the maximum share-

holder rate. Thus no shareholder will be advantaged by retention, while those who pay less than the maximum rate will be disadvantaged, so they will press for complete distribution of earnings in order to use the credit for taxes paid at the higher corporate rate. Since there will be no opposing pressure, the argument runs, management will have to respond by complete distribution of corporate earnings. Full partial integration where corporate earnings are completely distributed is necessarily equivalent to full integration.

Alternatively, since many shareholders will prefer to reinvest their dividends, a partial integration plan might permit constructive dividends (and integration) where reinvestment is desired without the need for cash payment and then reinvestment. The Canadian Carter Commission recommended that corporations be permitted to allocate after-tax corporate income to shareholders for gross-up and credit without having to pay cash dividends.[7] If such an allocation were made with regard to all retained earnings, as the pressures described in the last paragraph suggest it would be, the result would be equivalent to the attribution of retained corporate earnings to shareholders required under full integration.

Whether or not it is thought that these results are likely to occur in exactly the form given, this line of argument certainly indicates the likely pressure from lower bracket shareholders for distribution under partial integration if the corporate tax rate equals the maximum individual rate and the preference for capital gains is repealed. It also suggests that some sort of reinvestment mechanism may be desirable if partial integration is adopted under such circumstances.

Finally, to the extent there would no longer be an incentive to retain corporate earnings because corporate and maximum shareholder rates would be equivalent and the preference for capital gains eliminated, the penalty taxes aimed at preventing accumulation could be repealed, even without the adoption of integration.[8] If partial integration were to be adopted, however, and corporate preferences not passed through

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[7] 4 REPORT OF THE ROYAL [CANADIAN] COMMISSION ON TAXATION 51-57 (1966).

[8] Consider a corporation with $100 in retained earnings, where corporate and individual tax rates are 50 per cent and where there is neither a preference for capital gains nor a method of integration. As the table below indicates, there is no incentive to retain corporate earnings if it is assumed that the shareholder and the corporation have access to the same investments.

	Results If Earnings Distributed	Results If Earnings Retained
Year 1		
Corporate retained earnings	$ 100	$ 100
Distribution to shareholder	100	0
Shareholder tax	50	0
Available for investment	50 (by shareholder)	100 (by corporation)

to shareholders (a case discussed below), an incentive to retain earnings would reappear in certain instances.[9]

Year 2		
Gross return on investment (100 per cent profit)	100 (to shareholder)	200 (to corporation)
Corporate tax	0	50 (on $100 gain)
Cash distribution to shareholder	0	150
Shareholder tax	25 (on $50 gain)	75 (on $150 distribution)
Shareholder after-tax cash	75	75

The foregoing analysis applies to retained earnings, that is, earnings that have been subjected to the corporate tax, and demonstrates that there is no incentive to retain earnings. It does not apply to cash that a shareholder holds individually and that can be invested on individual account or through a corporation. If invested through a corporation, there will be less after all taxes for the shareholder than if he invested individually under the postulated conditions. Thus although the equivalence of rates described in the text eliminates any incentive for retention, even without integration, it does not provide equality of treatment for investments through corporate and noncorporate forms. That equivalence could, however, be achieved without integration by permitting a shareholder deduction for contributions to corporate capital. That combination—deduction for contributions, full taxation of earnings at the entity level, and full taxation (without integration) at the individual level on distribution—is the method of "integration" suggested by BLUEPRINTS for income from assets held by pension plans but not for corporate income. *See* DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 56-57 (1977).

[9] The procedure for denying a pass through of preferences is explained on pp. 325-331, where a shareholder credit limited to actual taxes paid is said to be the simplest. Consider a corporation under such a regime with $100 in preference income that can, as in note 8, be invested in an asset that will double in value in one year. If the corporate and shareholder tax rate under full partial integration is 50 per cent and there is no preference for capital gains, the results of distribution and retention are as follows:

	Results If Earnings Distributed	Results If Earnings Retained
Year 1		
Corporate economic income	$ 100	$ 100
Corporate taxable income	0	0
Corporate taxes	0	0
Cash distribution to shareholder	100	0
Grossed-up distribution to shareholder	100	0
Shareholder tax	50	0
Available for investment	50 (by shareholder)	100 (by corporation)
Year 2		
Gross return on investment (100 per cent profit)	100 (to shareholder)	200 (to corporation)
Corporate tax	0	50 (on $100 gain)
Cash distribution to shareholder	0	150
Grossed-up distribution	0	200 [a]
Shareholder tax	25 (on $50 gain)	50 [c]
Shareholder after-tax cash	75 [b]	100

[a] $150 cash distribution plus $50 corporate taxes paid.

[b] The same result would obtain if the shareholder had reinvested $50 in the corporation in year 1 and basis recovery was permitted in year 2.

[c] Gross shareholder tax of $100 (50 per cent of $200) minus credit for corporate tax paid of $50.

TECHNICAL PROBLEMS REGARDING INTEGRATION THAT LEAD TO INCREASED COMPLEXITY

As the preceding discussion suggests, mere implementation of the basic decision to integrate the individual and corporate taxes involves issues of considerable conceptual difficulty. It is bound to add some complexity to the tax law, although the exact quantum of complexity depends on the method and extent of integration chosen. Additional complexities will become evident as we examine some of the potential resolutions of the technical issues set forth above with regard to full integration. By far, the most difficult of these is the appropriate treatment of corporate tax preferences.

Corporate Preferences

The flow of corporate income includes receipts that are not taxed (such as interest from municipal bonds), costs that reduce taxable income by an amount in excess of true economic cost (such as the excess of accelerated depreciation over economic depreciation), and other items (such as the investment tax credit) that make available for distribution to shareholders cash that has not borne any corporate income tax. When the cash produced by these items, generally called "tax preferences," is distributed to shareholders, a fundamental policy decision must be made concerning whether its tax-free character is also to apply in regard to individual income taxation.

Full application of the ideal that individuals should be taxed as though they had earned the income from corporate assets individually or through a partnership suggests that the benefits of corporate tax preferences should be passed through to shareholders along with corporate income. On the other hand, it is possible to argue that partial integration, at least, is designed only to eliminate the current corporate tax on distributed earnings, not to reduce the current shareholder tax. Based on this viewpoint, for which earnings and profit are the closest conceptual precedents under current law, corporate preferences should not be passed through to shareholders.

Unfortunately, no matter what decision is made on this fundamental policy issue, significant complexity may be required in order to implement it. In addition, special rules may be required to prevent regulatory agencies from using the ratemaking process to preclude the desired result with respect to regulated industries.

We begin by examining the role of preferences under the shareholder

credit regime of partial integration, both because it is the most widely suggested method and because a dividend deduction raises similar problems if a withholding tax is adopted. We then turn to an examination of a dividend deduction without withholding and end with a word about full integration.

Shareholder Credit Method

Deduction and Exclusion Preferences. Once corporate preferences are introduced, the shareholder gross-up and credit does not yield the desired result, regardless of whether the policy decision is to pass preferences through. Consider a corporation with $40 of taxable income and $60 of preference income (or deductions) so that a corporate tax of $20 (at 50 per cent) is paid, after which the corporation distributes the remaining $80 to a 30 per cent shareholder. If the tax preferences are not to be passed through to shareholders, then the individual taxpayer should pay a tax of $30 on the $100 of gross "economic income" distributed (that is, the sum of taxable and preference income) reduced by the $20 in taxes already paid by the corporation for a net shareholder tax liability of $10. If, on the other hand, preferences are to be passsed through, the shareholder should have a gross tax liability of $12 (30 per cent of $40 distributed taxable income) and should receive a refund of $8 from the $20 paid on his account by the corporation.

Neither correct result is reached by simply grossing-up the $80 distribution on the basis of a 50 per cent corporate tax rate for a grossed-up dividend of $160 ($80 × 2). A shareholder whose marginal rate is 30 per cent would have a gross tax of $48 (30 per cent of $160), reduced by the credit of $80, for a refund of $32 and an overall negative tax payment of $12 from the Treasury with respect to the $100 of economic income from corporate assets. The problem with the shareholder credit mechanism when there are corporate preferences in the form of exclusions or deductions is that it erroneously assumes that corporate taxes have been paid on the preferred income.

Unfortunately, it is easier to articulate the alternative correct results in the foregoing hypothetical situation than it is to design a simple system that assures either of them. Suppose we thought it desirable to prevent corporate preferences from being passed through. At least four means of accomplishing that end are available. First, the individual shareholder could base his gross-up on the effective, rather than the nominal, corporate tax rate—20 per cent in the example above (that is, $20 divided by $100). This solution would require not only a different

gross-up rate for each corporation each year but also a computation of the corporation's economic income ($100), a hopelessly complex task. Second, an invariant shareholder gross-up rate could be based on an arbitrarily assumed effective corporate tax rate, with a second-level tax levied at the corporate level to make sure that at least that rate of tax had been paid on distributed income. This method would require the computation of the effective rate of the first-level tax (in order to arrive at the deficiency to be remedied by the second-level tax), a calculation that requires identification of economic income. Third, the shareholder could gross-up at the statutory rate, but only in regard to distributed taxable income. This would also eliminate the need for different gross-up rates, but would require a determination of how much of the distribution is taxable, rather than preference, income.

The final method avoids the need to measure corporate economic income but requires shareholders to gross-up by actual corporate taxes paid ($20 in the example given), rather than by a single rate for all corporations. The corporation would keep an accumulated federal taxes paid account and would notify shareholders of the amount of their gross dividends and the tax credit to be taken with respect to each cash distribution. This approach, which requires shareholders to do no more than wage earners now do with regard to amounts received as wages, appears to be the simplest method of partial integration and is the method on which the remainder of this paper will focus. It is equally accurately described as either (1) a corporate tax on income with a shareholder credit for that tax paid on account of distributed earnings or (2) a corporate tax on retained earnings only, along with a withholding tax on corporate distributions. Partial partial integration could be accomplished by adding only a portion of federal taxes paid to the cumulative account or, alternatively, by permitting shareholder gross-up and credit for only a portion of the balance in that account.

If it is thought desirable that corporate preferences be passed through to shareholders, then the need to define economic income reappears. As shown above, simply grossing-up and crediting does not accomplish the correct result, which requires that tax-preferred corporate income be identified as such and passed on in that form to shareholders. Identification of economic income would even be necessary under the accumulated-taxes-paid account approach if preferences were to be passed through because distributions to shareholders in excess of taxable income would have to be divided between economic income and returns of capital, if the earnings and profits requirement were not eliminated. (A return of capital should result in a basis adjustment, whereas untaxed

economic income should not, since a reduction in basis would create a future tax liability.)

Thus far, the discussion has focused on the extreme case of a complete distribution of current corporate earnings. If, as will almost always be the case, only a portion of corporate earnings is distributed, an addi-

		Preferences Not Passed Through	
	Taxable Income Distributed First	Preference Income Distributed First	Pro Rata (60 Per Cent Preference, 40 Per Cent Taxable Income)
Total cash distribution	$ 30	$ 30	$ 30
Preference income distributed	10	30	18
Taxable income distributed	20[a]	0	12
Grossed-up dividend	50[b]	30	42[c]
Gross shareholder tax	15	9	12.60
Shareholder credit for corporate tax	20	0	12
Net shareholder tax	(5)	9	.60
Total cash distributed	$ 30	$ 30	$ 30
Preference income distributed	10	30	18
Taxable income distributed	20[a]	0	12
Grossed-up dividend	40[d]	0	24[e]
Gross shareholder tax	12	0	7.20
Shareholder credit for corporate tax	20	0	12
Net shareholder tax	(8)	0	(4.80)

[a] $40 taxable income reduced by $20 corporate tax payment.
[b] $30 cash dividend grossed-up by $20 corporate tax payment.
[c] $30 cash dividend plus $12 gross-up of corporate taxes paid on account of $12 taxable income distributed.
[d] $20 cash distribution of taxable income grossed-up by $20 tax payment.
[e] $12 cash dividend of taxable income grossed-up by $12 corporate taxes paid on account of $12 taxable income distributed.

tional complexity is introduced: Are the earnings to be considered out of taxable income (net of taxes) or out of tax-preferred income or pro rata out of both? Suppose in the example above, that is, $100 of economic income divided between $40 of taxable income and $60 of preference income, only $30 is distributed to our 30 per cent shareholder. Even the conceptually correct results in this case depend on which of the three stacking rules is preferred.

Of these six potentially correct answers, several are superior on the basis of simplicity. Any program that involves a pro rata division of cash distributions between taxed and untaxed income requires measurement of economic income, as do some proposals that pass through preferences. On the other hand, stacking preferences last (that is, assuming distributions come first out of taxable income) substantially reduces the complexity of integration. That stacking rule avoids the necessity of deciding whether distributions are returns of capital, rather than preference income, until distributions exceed taxable income. To be weighed against the advantages of stacking preferences last and not passing them through to shareholders are any harmful effects such a system might have on corporate payout policy, such as discouraging distributions in excess of taxable income.

In short, the simplest method of full partial integration is for shareholders to gross-up distributions by the corporation's statutory income tax rate, limited by the actual corporate taxes paid, with preferences stacked last. (In the interest of simplicity, the examples generally deal with a single year, but since taxable income is not always distributed currently, the limitation to corporate taxes paid should be applied on a cumulative basis.) Consider again a corporation with no accumulated taxes or earnings, current economic income of $100, preference income or deductions of $60, taxable income of $40, a corporate tax rate of 50 per cent, and a shareholder tax rate of 30 per cent. The table on page 330 illustrates the results of various distributions after the corporation pays taxes of $20.

The differences shown between the proposal and present law are precisely the amounts by which present law "overtaxes" corporate distributions, if the problem is seen as a failure of the current system to apply the shareholder's tax rate (and only that tax rate) to distributed earnings. The difference of $14 represents the "extra" 50 per cent corporate tax paid on the $40 of corporate earnings that is "double taxed" ($20) minus the 30 per cent shareholder tax ($6) saved under current law because that corporate tax is not included in the shareholder's tax base. Similarly, the $7 difference with regard to a dis-

Cash distribution	$ 10	$ 46	$ 50	$ 80
Shareholder gross-up	+10	+20	+20	+20
Grossed-up dividend	20	66	70	100
Gross shareholder tax	6	20	21	30
Shareholder credit for corporate tax	10	20	20	20
Net shareholder tax	(4)	0	1	10
Corporate tax on distribution	10	20	20	20
Total tax on distribution under integration proposal (corporate plus shareholder)	6	20	21	30
Total tax on distribution under current law (corporate plus shareholder)	13(10+3)	34(20+14)	35(20+15)	44(20+24)
Difference between total tax under current law and proposal	7	14	14	14

tribution of $10 represents the "extra" 50 per cent corporate tax paid thereon ($10) minus the 30 per cent shareholder tax thereon ($3) not collected under present law. Like the earnings and profits concept of the current law, the suggested approach does not pass preferences through to shareholders.

If it were thought desirable to permit the pass-through of corporate preferences, this approach could be applied to distributions out of taxable income only. When distributions exceeded taxable income, which would be stacked first, the additional amounts would be treated as tax-free distributions to shareholders, although decisions would be necessary concerning when basis adjustments would be required. If partial partial integration were desired (perhaps as a phase-in of full partial integration), this approach could be used by giving shareholders a credit for only a portion of the corporate taxes paid or by adding less than the full amount of corporate taxes paid to the accumulated tax account at the corporate level.[10]

Finally, a second-level corporate tax could be added to the usual

[10] Like all forms of partial partial integration, this variant would make corporate preferences worth more to some corporations with integration than without it.

(first-level) corporate tax under this approach to provide a standard gross-up rate for shareholders. Computation of economic income would not be required if preferences were not passed through and taxable income stacked first, since the second-level tax could reduce taxes otherwise payable (and added to the cumulative-tax-paid account), just as the ACT reduces mainstream liability under the system in the United Kingdom. At least one published report has indicated that this last variant—second-level tax, partial partial preferences not passed through—is the method of shareholder credit partial integration favored by the Carter Administration.[11]

Although these alternatives appear to be the simplest available methods of partial integration via the shareholder credit mechanism, they obviously involve some increase in complexity. Moreover, it is worth repeating that partial integration by any other method will lead to essentially the same results if a corporate withholding tax is enacted along with a dividend deduction or split rate.

Credit Preferences. Thus far, only preferences in the form of deductions or exclusions have been discussed. Preferences in the form of tax credits, such as the investment credit (ITC), raise the same policy issue of whether to pass through or not but are somewhat easier to handle from the viewpoint of simplicity. A corporation with $100 in (economic and) taxable income and a $50 federal income tax liability offset by a $30 ITC will have $80 available for distribution. If integration is to result in a 30 per cent shareholder being taxed at his own marginal rate, the conceptually correct results in the case of a complete distribution, depending on whether or not the benefit of the ITC is to be passed through, are shown in the following table:

	ITC Passed Through	ITC Not Passed Through
Shareholder taxable income	$100	$100
Gross shareholder tax	30	30
Investment tax credit	30	0
Net shareholder tax	0	30
Net cash to shareholder	100	70

Unfortunately, neither simply grossing-up the $80 distribution in accordance with the 50 per cent corporate rate nor treating the $30 ITC as taxes paid reaches either correct answer:

[11] BNA DAILY TAX REPORT, at J-49 (October 7, 1977) (special supplement).

	Gross-Up at 50 Per Cent Corporate Tax Rate	ITC Treated as Corporate Taxes Paid
Cash distribution	$ 80	$ 80
Grossed-up distribution	160[a]	130[b]
Gross shareholder tax	48	39
Shareholder credit for corporate tax	80	50
Net shareholder tax	(32)	(11)

[a] $80 × 2 = $160.
[b] $80 cash distribution plus $20 taxes paid plus $30 ITC.

The problem with these results is that the process of grossing-up adds the investment tax credit to the shareholder's taxable income, thus distorting its effect, which should only be against taxes due. The correct answer is obtained for pass-through if the ITC is not included in the gross-up but is included in the credit against shareholder taxes. For the nonpass-through solution, the ITC should be neither grossed-up nor credited.

	ITC Not Included in Gross-Up, But Credited	ITC Neither Grossed-Up Nor Credited
Cash distribution	80	80
Grossed-up distribution	100[a]	100[a]
Gross shareholder tax	30	30
Shareholder credit for corporate tax	50[b]	20[c]
Net shareholder tax	(20)	10
Net cash to shareholder	100	70

[a] $80 cash distribution plus $20 corporate taxes paid.
[b] $20 corporate taxes paid plus $30 ITC.
[c] $20 corporate taxes paid.

As in the case of deduction and exclusion credits, there is thus a relatively simple method of integrating corporate preferences, whether they are to be passed through or not. Moreover, it is arguably easier to identify the credit preferences if pass-through is desired, and it does not seem necessary to decide whether the preferences should be "stacked" in any way, although a less than complete distribution of accumulated taxes should presumably carry only a pro rata portion of the credit preferences to shareholders. Finally, since the manner of treating credit preferences is different from that for deduction and exclusion prefer-

ences, it is possible to pass through the one, but not the other, if any policy reasons are thought to support such a result.

The investment tax credit is currently subject to the limitation that it may not exceed approximately 50 per cent of the taxpayer's tax liability. If the credit were to be passed through and the limitation retained in some form, considerations of simplicity suggest that the limitation be applied at the corporate level. Computation of the limitation at the shareholder level, which is probably more consistent with the theory of integration, would involve a significant increase in complexity for individual taxpayers.

Dividend Deduction Method. Even without a withholding tax, the dividend deduction method of partial integration again involves a variety of potentially correct answers, depending on whether preferences are to be passed through or not and whether distributions are to be assumed to be first from taxable income, first from preference income, or pro rata from each. As in the case of the shareholder credit, the simplest policy to implement would be the denial of pass-through: The corporation would deduct distributions while shareholders would include all distributions in income. (Alternatively, the corporation might be permitted a deduction only to the extent that the distribution was out of taxable income.)

If preferences would be passed through, the dividend deduction method would become more complex because, as under the shareholder credit, the shareholder would have to exclude the appropriate amount of preference items from his taxable income. If taxable income were distributed first, the corporation would deduct distributions, which would be included in income by the shareholder to the extent of taxable income. The other stacking rules (preferences first or pro rata) would lead to different amounts included in shareholder income.

As in the case of the shareholder credit, the conclusion that can be drawn from the foregoing analysis is that there is a fairly simple method of implementing integration if one of a number of possible policy alternatives is favored, that is, no pass-through and, perhaps, taxable income stacked first. If pass-through is desired, the now familiar problems of defining economic income occur, although they can be ameliorated by stacking taxable income first. Credit preferences can be treated under the dividend deduction just as they were under the shareholder credit, but without the gross-up. A credit against individual taxes can be given if pass-through is desired, and denied if not.

Full Integration. If retained earnings were to be taxed only at the shareholders' rates, then computation of those earnings would be required, even if preferences were not to be passed through. The calculation of retained earnings (or total corporate earnings under the *Blueprints* approach), as defined for financial reporting purposes, might well be unacceptable as the basis for taxation of individual shareholders. In that event, a new definition would be required to isolate that type of corporate income—presumably all economic income if there were to be no pass-through—that should generate tax liability for shareholders, regardless of whether it is distributed.

Other Technical Problems Involving Complexity with Regard to Full or Partial Integration

Although the following problems involve considerable complexity, they are probably not as difficult in that regard as corporate preferences and will, accordingly, receive less detailed treatment. Again, the principal focus will be on the shareholder credit method.

International Problems. As indicated above with regard to full integration, at least three fundamental issues of international tax policy are raised by domestic integration: (1) Should United States shareholders be permitted a credit for foreign taxes paid by United States corporations? (2) Should foreign shareholders of United States corporations be permitted the tax benefits of whatever United States integration plan is adopted? (3) Should foreign taxes paid by foreign corporations be integrated with the individual income of the United States shareholders of these corporations?

The first issue raises the question of whether the foreign tax credit (FTC) should be passed through to shareholders and involves many of the same considerations as the appropriate treatment of the investment tax credit discussed above. A negative answer can be implemented by denying the gross-up and credit for the FTC, which apparently has the effect of converting the FTC into a deduction for the shareholder.[12]

[12] Consider a corporation with \$100 in taxable income, \$30 in foreign tax liability, and a 50 per cent rate of United States corporate tax. The corporation will pay \$20 in United States taxes (after the foreign tax credit), leaving \$50 available for distribution to shareholders. A distribution of that \$50 will be grossed-up to \$70 on account of the United States taxes paid and, if made to a 30 per cent shareholder, yield a gross shareholder tax of \$21 and a net shareholder tax of \$1 (\$21 − \$20 = \$1). The shareholder will thus retain \$49 after all taxes. That is precisely the amount the shareholder would

although that result would seem to offend the very investment neutrality that is said to be the FTC's rationale.

The full value of the FTC could, on the other hand, be passed through by treating the amount of the FTC as United States income tax for purposes of both the gross-up and the shareholder credit, since, unlike the ITC, taxes were actually paid by the corporation in the amount of the FTC. One result of that procedure would be that lower bracket shareholders would receive refunds from the United States Treasury for taxes paid by the corporation to foreign governments. If that possibility were thought undesirable, potentially complex accounting rules could be developed at the corporate level to segregate United States and foreign taxes paid, in order to apportion shareholder distributions and the FTC between United States and foreign source income. In this way, shareholders would only receive some portion of the FTC. Finally, to the extent the FTC was passed through, computation of its limitation should, like the investment tax credit limitation, be made at the corporate level in the interests of simplicity.

In regard to the second issue, the principal complexity problem is identification of the United States rate of tax and its effect on foreign shareholders in United States corporations. Although the shareholder credit method may be identical to the dividend deduction method with withholding, the United States rate of "corporate," as opposed to "withholding," tax is different under the two methods. To return to the example on page 322, the "corporate" tax rate under the shareholder credit is 50 per cent, while it is 25 per cent under the dividend deduction. Although it might be desirable for domestic political purposes to characterize the tax collected from corporations with respect to distributions under an integration plan as mere "withholding" rather than as a separate corporate tax, precisely the reverse might be true for treaty negotiation purposes.

Indeed, all three of the foregoing issues are matters subject to treaty negotiation. Thus whatever resolutions are suggested must be made with an eye toward the potential reactions of other countries.

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have retained if he had earned the $100 on individual account and had taken the foreign tax payment as a deduction rather than a credit:

Taxable income before foreign tax	$100
Foreign tax	−30
Taxable income after foreign tax	70
United States tax	21
Retained after United States and foreign tax	49

Tax-Exempt Entities. A dividend deduction without withholding would presumably benefit tax-exempt shareholders by permitting increased dividend payments or by increasing the value of corporate shares, if the tax savings were retained at the corporate level. On the other hand, the benefits of a shareholder credit (or withholding) plan could, as an initial matter, be denied to tax-exempt organizations by making the credit (or withholding) nonrefundable. If corporations reduced cash dividends to offset the credit available to tax-paying shareholders, tax-exempt entities might receive even smaller cash dividends from their portfolio holdings than they did before integration.

Nevertheless, it is possible that tax-exempt entities would still capture a significant part of the value of integration by selling their shares to taxpayers who would be able to make use of the credit for taxes paid or withheld. If it is thought likely that tax-exempt entities would benefit by this kind of capitalization of the tax reduction, it might be desirable to permit them the benefits of integration directly rather than mandating the transaction costs and tax bias against equity investment implicit in the divestiture of corporate stock. Either a refundable credit or a withholding exemption, depending on the integration plan used, would accomplish this result.

Finally, the extension to tax-exempt entities of the benefits of integration might require reexamination of the underlying decision not to impose a tax on corporate earnings distributed (and retained in the case of full integration) with respect to shares held by these entities.

Audit Adjustments. How should audit adjustments be reflected under a plan of integration? *Blueprints* suggests making the adjustments to income in the current year on the theory that the market will adjust for potential tax liabilities precisely as it does under existing law. That solution is certainly superior on simplicity grounds to the alternative of attributing items of additional income, deduction, or whatever to shareholders of previous periods. Some countervailing considerations that must be weighed against the simplicity benefits of that proposal are whether there would be additional demands for disclosure of potential tax liabilities by corporate management if individual shareholder income were to be directly affected (and whether such pressure is beneficial) and whether there would be different pressures on management from shareholders with regard to litigation of these issues.

Multiple Corporations and Tax Attributes. Partial or full integration of the taxes on corporate earnings raises the issue of the appropriate role thereunder of the deduction for dividends received by corpora-

tions. Since that deduction removes the dividend from the receiving corporation's taxable income, presumably it should not also be able to take a credit for taxes paid by the transferor corporation. Even if the receiving corporation were not permitted a credit, it would have to keep track of that credit so that it could be passed on to individual shareholders when a distribution was made to them. Alternatively, the dividend-received deduction might be repealed and corporations treated like any other shareholders. In that case, a decision would be required concerning whether some limitation should be enacted for insufficiently related corporations, just as the dividend-received deduction is now limited in the case of corporations other than members of an affiliated group.

Changes of corporate form, as in the case of tax-free reorganizations, raise the issue of whether new tax attributes, such as the accumulated-taxes-paid account, should be carried over (as in acquisitions) or somehow distributed (as on liquidation to individual shareholders) because of fundamental corporate changes and whether there should be any special limitations on these carryovers and distributions. These changes also raise the issue of whether postmerger shareholders would be adequately protected by warranties at the corporate level for postmerger audit changes.

A related question under full integration is whether the availability of losses, passed through or carried forward, would generate share purchases by higher bracket shareholders to capture the losses once they became known and whether special provisions would be required to prevent these purchases. The choice of the first day of the taxable year as the date of attribution might substantially mitigate, if not eliminate, this problem in the case of pass-through, since losses are, perhaps, unlikely to be predictable at that time.

Finally, net operating loss carrybacks, even in the case of a single corporation, raise the issue of their appropriate effect on the integration mechanisms, such as the accumulated-taxes-paid account, in the earlier year.

Technical Problems Involving Complexity with Regard to Full Integration Only

Sales of Stock. If retained earnings are attributed to shareholders under full integration, a choice would have to be made of the appropriate shareholder for attribution where shares are transferred during the taxable year. The *Blueprints* proposal for full integration provides

that corporate income would be attributed to shareholders of record on the first day of the corporate taxable year. If shares were sold during the year, the seller would compute his gain or loss by subtracting his basis from the amount realized, as under current law. At the end of the year, when income is imputed, there would be no need for further adjustment by the selling shareholder, since the income imputation would be offset by the correlative basis adjustment.

The efficacy of this plan depends on the elimination of the differential treatment of capital gains and ordinary income to make the basis adjustment equal the simultaneous imputation of income. Moreover, the effect of the plan is to defer payment of any tax on corporate income earned between the date of sale and the end of the corporation's taxable year until the buyer sells his shares. This result eventuates because the imputation to the seller of income for the full year is offset by his simultaneous basis adjustment. Postsale earnings are thus taken into income only by the higher tax paid (due to a lower basis) when the stock is ultimately sold by the buyer. Any attempt to eliminate this deferral would likely involve the additional complexity of allocating a portion of the earnings to the buyer in the year of purchase.

Attribution and Liquidity. Full integration would require shareholders to pay taxes on retained earnings, which they have not received. This suggests the enactment of a withholding tax at the corporate level. If the *Blueprints* method of attribution were adopted, shareholders who held shares of stock for the entire year would simply take a credit for their share of the withheld corporate taxes.

Shareholders who sold their shares during the year and who had income attributed to them could also take credit for taxes withheld on their account, even though they would no longer be shareholders. Although posttransfer corporate gains or losses would affect the size of the year-end credit so that a selling shareholder would retain an interest in the postsale earnings of the corporation, the simplicity of such a system might outweigh the possible failure of the market to fully reflect the value of the future credit when the stock would be sold.

The *Blueprints* proposal assumes that corporate income will have been determined at the time the shareholder files his return. This is an assumption that may not be warranted, especially if the corporation and shareholder use different taxable years. Finally, neither the *Blueprints* proposal nor any other proposal offers an easy solution to the

difficult problem of allocating undistributed earnings among holders of common stock, preferred stock, convertible preferred stock, convertible debentures, and so on.

Tax Shelters. Full attribution of corporate losses to individual shareholders would permit the use of corporations for the marketing of tax shelters, much as partnerships have been used in recent years. If the addition of the corporate device were thought undesirable, potentially complex limitations on amounts passed through to shareholders would be required. Whether these limitations would be in the nature of the at-risk rule, the minimum tax, or some other limitation, they would presumably require identification of particular categories of corporate expenditures and receipts for special treatment by shareholders. This process would be much more complicated than simply passing through net income or loss. An alternative solution would be to deny pass-through of corporate losses but permit their carryforward against future corporate income (prior corporate income already having been passed through and taxed to shareholders), although this solution would not be entirely consistent with the rationale of full integration.

CONCLUSIONS

Recent political interest in integration of the individual and corporate income taxes may appear to be a counterproductive development for a conference on simplification, for integration involves a host of new conceptual and technical complexities. Those complexities may, however, be manageable if certain constraints on the available policy options are accepted, such as avoidance of any regime that requires a calculation of corporate economic income. The ultimate issue is whether the policy goals accomplished by integration are worth the necessary increment in complexity, reduced by the simplification gains, if any, that are also a concomitant of integration. Unfortunately, there is no single comprehensive answer to that inquiry. Instead, the resulting balance depends on the precise method of integration chosen and its accommodation to each of the complexity considerations raised above.

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Simplification for Business Taxpayers: ERISA—Was All This Really Necessary?

John R. Lindquist

BACKGROUND

Although the nontax provisions of the Employee Retirement Income Security Act of 1974 [1] provide a significant measure of complexity by themselves, this paper will be limited to a discussion of the complexity introduced into the Internal Revenue Code by the enactment of ERISA.[2] This is not to say that the Code provisions and regulations relating to qualified pension, profit-sharing, and stock bonus plans in existence before ERISA were simple. Although the pre-ERISA Code already contained complex qualification requirements, those provisions had remained substantially unchanged for 32 years,[3] and persons compelled to deal with them on a daily basis, both inside and outside the government, were reasonably conversant with the requirements.

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* John R. Lindquist is a member of McDermott, Will & Emery, Chicago, Illinois.

** The author of this paper is indebted to his associate, Peter M. Kelly, Esquire, for his invaluable assistance, without which this paper probably would not have been completed.

1 Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 26, and 29 U.S.C.) [hereinafter cited as ERISA].

2 ERISA is divided into four titles. Titles I, III, and IV are codified almost exclusively in 29 U.S.C. and deal with reporting, minimum eligibility, vesting standards, fiduciary standards, enforcement and administration of ERISA rights, and plan termination insurance. Title II of ERISA contains the tax provisions that are the subject of this paper. The provisions of Title II are codified in 26 U.S.C. as amendments to the Internal Revenue Code of 1954.

3 *Private Pension Plans: Hearings Before the Subcomm. on Fiscal Policy of the Joint Economic Comm.,* 89th Cong., 2d Sess. 415 (1966) (statement of Assistant Secretary of the Treasury Stanley S. Surrey). The prohibitions against discrimination in favor of highly paid employees were the source of most of the complex rules to which qualified plans were subject prior to ERISA. These prohibitions find their genesis in the Revenue Act of 1942. Pub. L. No. 753, § 162 (a), 56 Stat. 862.

The Report on Tax Simplification [4] mentions four general trends that are major causes of complexity in the Code. ERISA epitomizes two of these trends. The first is the general trend to rely upon our tax laws to achieve social and economic goals that are deemed desirable.[5] The second is the trend to "fine tune" or "target" so-called tax expenditure provisions to be certain that the tax expenditure involved is available only when intended.[6] This has led to what is called "excessive statutory detail." [7]

Before considering what the stated objectives of ERISA were, it may be helpful to examine the background against which it was enacted. The private pension system to which ERISA was addressed was indeed diverse. It had grown steadily since 1942 [8] but in many different directions.

An example of this diversity is the development of the typical Taft-Hartley type of pension fund.[9] These plans were common in some

[4] Staff of the Joint Comm. on Taxation, Issues in Simplification of the Income Tax Laws, 95th Cong., 1st Sess. 3 (1977) [hereinafter cited as Joint Comm. Staff Report]. The report attributes tax complexity primarily to: (1) tax policies designed to achieve greater equity and to promote various economic and social objectives; (2) the necessity for compromise in formulating tax policy; (3) time and revenue constraints applicable in the development of legislation; and (4) the tendency to "fine tune" or to carefully draw legislation to limit an incentive to a particular situation, to render a provision administratively feasible, or to prevent tax avoidance or evasion.

[5] *Id.* The favorable tax treatment afforded to qualified pension plans is designed to be an incentive to the establishment of private plans as supplements to social security and personal savings. President's Comm'n on Corporate Pension Funds and Welfare Programs, Public Policy and Private Pension Programs i-ii, vi-viii, 1-5 (1965) [hereinafter cited as Presidential Report]. The role of the private pension system as a source of retirement savings has been accentuated recently as concerns have been expressed regarding demographic trends that indicate an expansion in our retirement population. Advisory Council on Social Security, Report on Social Security Cash Benefits Program, BNA Daily Report for Executives 7 (Spec. Supp. March 7, 1975); E. Allen, J. Melone & J. Rosenbloom, Pension Planning 2-7 (3d ed. 1976) [hereinafter cited as Pension Planning]; W. Greenough & F. King, Pension Plans and Public Policy 1-5, 18-24, 91-99, 106-108 (1976) [hereinafter cited as Pension Policy]; D. McGill, Fundamentals of Private Pensions 3-6, 13, 28 (3d ed. 1975) [hereinafter cited as Pension Fundamentals]; N. Ture, The Future of Private Pension Plans 6-7, 30-33, 59-75 (1976) [hereinafter cited as Future of Pensions].

[6] Joint Comm. Staff Report, *supra* note 4, at 3, 41.

[7] Joint Comm. Staff Report, *supra* note 4, at 35.

[8] The remarkable growth of the private retirement system began during the 1940's. For discussions of the factors contributing to the growth of private plans during this period, *see* Pension Planning, *supra* note 5, at 9-11; Pension Policy, *supra* note 5, at 43-49, 60-65; Institute of Life Insurance, Pension Facts 1975, 9-10 (1975) [hereinafter cited as Pension Facts 1975]; Pension Fundamentals, *supra* note 5, at 23-28; Presidential Report, *supra* note 5, at 1-5; Future of Pensions, *supra* note 5, at 23-26. For statistics evidencing the steady growth of private plans since 1940, *see* Pension Facts 1975, *supra* at 19; Future of Pensions, *supra* note 5, at 16.

[9] Taft-Hartley Pension Funds are maintained pursuant to an exception to the Taft-Hartley Act prohibition against employer payments to employee representatives. Labor Management Relations (Taft-Hartley) Act, § 302, 29 U.S.C. § 186. The trustees of these

industries in which numerous small employers are involved, and multiemployer collective bargaining is the norm (such as the building trades, the garment industry, and the trucking industry). Contributions in fixed cents-per-hour, dollars-per-shift, or dollars-per-week were usually contemplated.[10] At the same time, pension promises of fixed benefits were also made under these plans.[11]

These plans combined elements of defined contribution plans [12] and defined benefit plans [13] and, as such, defied conventional "pension wisdom" as it had developed up to the time of their emergence. Under that conventional wisdom, contributions could be fixed in amount, in which case they were money-purchase pension plans, with benefits equal to whatever the funds contributed would provide.[14] Under a conventional money-purchase pension plan, however, individual accounts for covered employees were maintained.[15] This was not true of the multiemployer fixed contribution–fixed benefit plans. On the other hand, prior conventional pension wisdom said that where benefits were fixed, contributions would have to be variable.[16] As these plans developed, it might have been wiser for the Internal Revenue Service to say that the plans simply would not qualify unless individual accounts were maintained and benefits were limited to what each individual's account would provide. Instead, the Internal Revenue Service strained to find a way to approve these plans as defined benefit plans.[17]

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funds are selected equally by the employers contributing to the fund and by representatives of the sponsoring union. *Id.* § 302(c)(5), 29 U.S.C. § 186(c)(5).

10 *See, e.g.,* U.S. Dep't of Labor, Digest of Selected Pension Plans 49-54, 61-62 (building trades), 45-46, 85-86, 89-90, 143-44 (garment industry), 195-98 (trucking industry) (1973 ed.) [hereinafter cited as 1973 Digest].

11 *Id.*

12 Defined contribution plans provide for annual contributions in a definitely determinable amount. Upon retirement, participants receive the entire amount in their individual accounts. Individual accounts fluctuate in value to reflect investment gains or losses. No promise of a fixed benefit is made under such an arrangement. *See generally* Treas. Reg. § 1.401-1(b)(1) (1956); IRS Employee Plans Training Program, (CCH) §§ 2.0-4.0, at 11-16 (1975) [hereinafter cited as IRS Training Program].

13 Defined benefit plans provide for the payment of a fixed or determinable benefit upon retirement. Contributions are determined in accordance with actuarial factors and assumptions. Gains or losses on investments may cause contributions to fluctuate but will not modify the amount of a participant's promised benefit. *See generally* Treas. Reg. § 1.401-1(b)(1) (1956); IRS Training Program, *supra* note 12, §§ 7.0-7.2, at 22-25.

14 A money-purchase pension plan is one variety of defined contribution plan. *See* note 12, *supra*.

15 *Id.*

16 *See* note 13, *supra*.

17 P.S. No. 64, Nov. 9, 1950, Pens. Plan Guide (CCH) ¶12,665, at 12,895 (2d ed. 1970), *superseded by* Rev. Rul. 70-257, 1970-1 C.B. 90. The difficulties in categorizing these plans have been illustrated in a recent case in which it was determined that such plans are not defined benefit plans subject to the termination insurance program. *Connolly v. PBGC*, 419 F. Supp. 737 (C.D. Col. 1976). Since the IRS position is based upon a conclusion that such plans are defined benefit plans, it is impossible to reconcile that position with the *Connolly* decision.

In other segments of industry where employers were organized, bargaining about retirement benefits was done on an individual basis, with large collective bargaining units and large employers involved. The automobile, agricultural implement, aerospace, aluminum, steel, rubber, and communications industries are examples. Collective bargaining here was concerned with benefit levels, not cents per hour or dollars per shift.[18] Even here, however, there were differences in approach.

Long ago, the United Auto Workers (UAW) obtained a funding commitment from the employers with which it bargains.[19] That funding commitment differed little from the minimum funding standards now required of all defined benefit plans under ERISA.[20] The *quid pro quo* for this funding commitment was that liability of the employer upon any termination of the plan would be limited to the assets of the funding medium employed.[21] Moreover, the UAW long ago bargained for and achieved vesting of benefits as favorable as that now required under ERISA.[22]

In the basic steel industry, on the other hand, no funding commitment was made that was comparable to that which existed in the industries that bargained with the UAW;[23] however, the employers' liabilities were not limited to the assets of any funding medium that might have been established either.[24] A case could have been made under the common law of contracts that the steel industry had un-

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[18] *See, e.g.*, 1973 DIGEST, *supra* note 10, at 83-84, 95-96 (automobile industry), 113-14 (agricultural implement industry), 133-34 (aerospace industry), 11-12, 177-78 (aluminum industry), 17-18, 111-12, 205-06 (steel industry), 77-78, 99-100, 201-02 (rubber industry), 97-98, 187-88, 109-10 (communications industry).

[19] *See* Fairweather, *Recent Pension Plan Settlements*, 1 LAB. L.J. 623, 627 (1950) (Ford settlement) [hereinafter cited as *1950 Pension Settlements*]. For an example of the funding commitments made before ERISA by the automobile industry, *see* General Motors Hourly-Rate Employees Pension Plan, Art. V, § 2, as in effect June 1, 1974, PENS. PLAN GUIDE (CCH) ¶ 43,631, at 31,228 (2d ed. 1974) [hereinafter cited as GM Plan]; Supplemental agreement dated Nov. 19, 1973, between General Motors Corp. and UAW, § 2, PENS. PLAN GUIDE (CCH) ¶¶ 43,503-43,516, at 31,202-04 (2d ed. 1974) [hereinafter cited as GM Agreement].

[20] *Compare* note 19, *supra*, *with* I.R.C. § 412.

[21] *E.g.*, G.M. Plan, *supra* note 19, Art. V, § 3(b) and Art. IX, § 2, PENS. PLAN GUIDE (CCH) ¶¶ 43,633-43, 634, and 43,660-43,666B, at 31,228 and 31,232-34 (2d ed. 1974); GM Agreement, *supra* note 19, § 2(c), PENS. PLAN GUIDE (CCH), ¶ 43,516, at 31,204 (2d ed. 1974). *Cf. 1950 Pension Settlements*, *supra* note 19, at 627-28.

[22] *See* BANKERS TRUST CO., 1965 STUDY OF INDUSTRIAL RETIREMENT PLANS 110-15 (1965) (vesting generally after 10 years). One of the permissible minimum vesting rules under ERISA is full vesting after 10 years. I.R.C. § 411(a)(2)(A).

[23] *See 1950 Pension Settlements*, *supra* note 19, at 627-28. *E.g.*, agreement dated Aug. 1, 1971, between the United States Steel Co. and the United Steel Workers, PENS. PLAN GUIDE (CCH) ¶ 43,700 *et seq.*, at 31,301 (2d ed. 1975) [hereinafter cited as U.S. Steel Plan].

[24] *See 1950 Pension Settlements*, *supra* note 19, at 627-28. *E.g.*, U.S. Steel Plan, *supra* note 23, §§ 1.3, 11.2, PENS. PLAN GUIDE (CCH), ¶¶ 43,712, 43,778, at 31,303 and 31,319 (2d ed. 1975).

limited liability for pensions that had become payable.[25] Vesting under the basic steel pension pattern was limited to certain forms of early retirement and to situations in which employment was terminated as a result of a plant or department shutdown.[26]

Turning to the section of business and industry where employees had not organized, many of those employers also had established qualified plans. Whether because of the Internal Revenue Service's insistence upon vesting as a prerequisite to qualification[27] or because of competitive pressures in the labor market,[28] most of the plans maintained by these employers provided some form of vesting before retirement.[29] Often, that vesting exceeded the vesting required by ERISA.[30] Many of these plans were profit-sharing plans and, for this reason, minimum funding standards were not applicable.[31] Where those employers maintained defined benefit plans, funding usually equalled or exceeded minimum funding standards now imposed by ERISA.[32]

It was against this diverse backdrop that ERISA was enacted. It is not surprising that the result was a lengthy and complex statute. It was much the same as if a physician, faced with a room full of patients, some having chest pains, others suffering from colds or broken limbs, and others about to give birth, all clamoring for treatment at once, were to prescribe the same medicine in the same dosage for all, despite the fact that it might kill some patients while helping others.

Continuing the medical analogy, this is just what ERISA has done.

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[25] For a collection of pre-ERISA cases, *see* PENS. PLAN GUIDE (CCH), ¶7,825, at 8,012 (2d ed. 1970). *Cf. 1950 Pension Settlements, supra* note 19, at 628. It is interesting to note that in theory the limitation on employer liability contained in § 4062 of ERISA may have actually reduced the potential liability of the employers in the steel industry. ERISA § 4062(b), 29 U.S.C. § 1362(b). For a discussion of the present magnitude of the underfunding problem in the steel and other industries and the possibility that the 30 per cent of the net worth liability limitation may actually offer an incentive to terminate, *see* Ehrbar, *Those Pension Plans Are Even Weaker Than You Think,* FORTUNE 104 (Nov. 1977).

[26] *See* BANKERS TRUST CO., 1975 STUDY OF CORPORATE PENSION PLANS 224-29 (1975).

[27] Because of the potential for prohibited discrimination, the Internal Revenue Service required many employers to adopt fairly rapid vesting in their plans. *Compare* Rev. Rul. 71-150, 1971-1 C.B. 123, *with* Rev. Rul. 68-302, 1968-1 C.B. 163, *and* Rev. Rul. 71-151, 1971-1 C.B. 123.

[28] For discussions of the competitive pressures that have led to the establishment of plans or the improvement of plan benefits, *see* PENSION PLANNING, *supra* note 5, at 11-12; PENSION FUNDAMENTALS, *supra* note 5, at 21-23.

[29] *Cf.* BANKERS TRUST COMPANY, 1972 STUDY OF EMPLOYEE SAVINGS AND THRIFT PLANS 24-26 (1972).

[30] *Id. See also* PRESIDENTIAL REPORT, *supra* note 5, at 33-36, app. tables 6-8; C. TROWBRIDGE, *Private Pension Funding and Vesting—Where Do They Stand Today,* in PRIVATE PENSIONS AND THE PUBLIC INTEREST 57, 67-69 (1969) [hereinafter cited as *Funding and Vesting*].

[31] *See* note 12, *supra.*

[32] Griffin, *Pension Security and Funding Regulation,* XIV PROCEEDINGS OF CONF. OF ACTUARIES IN PUBLIC PRACTICE 1 (1964-1965). *Cf. Funding and Vesting, supra* note 30, at 63-67, *with* I.R.C. § 412.

Despite attempts to discount the facts,[33] it is undeniable that since ERISA a substantial number of plans have been terminated.[34] Further, unless we assume that the Pension Benefit Guaranty Corporation (PBGC) is misleading Congress in requesting increases in the premiums for plan termination insurance, more terminations are on the way, with substantially increased liability for the PBGC.[35]

Although the basic purpose of this paper is to discuss how the Internal Revenue Code might be simplified without sacrificing any significant goals of ERISA, it may well be that a collateral benefit of adoption of the approach suggested might be the preservation and extension of the private pension system. This, in turn, might ease the almost certain pressure for increased social security benefits that will

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[33] *E.g.*, Letter from Labor Dep't Administrator of Pension and Welfare Benefit Programs, William J. Chadwick, to Senator Gaylord Nelson (Nov. 16, 1976), *reprinted in* B.N.A. DAILY REPORT FOR EXECUTIVES at J-1 (Nov. 26, 1976); *Congressional Research Service Report on Pension Plan Terminations*, 129 PENS. REP. (BNA) at R-24 (March 21, 1977) [hereinafter cited as *Congressional Research Report*]. Both Mr. Chadwick and the *Congressional Research Report* discounted ERISA as a cause of terminations because plan administrators have not described their plan terminations as resulting from ERISA. Evidently, neither Mr. Chadwick nor the author of the *Congressional Research Report* is aware of the fact that the Internal Revenue Service has been threatening to retroactively disqualify plans that are terminated solely because of ERISA. This practice has been followed even though the Service's own training manual refers to changes in the law governing retirement plans as a "substantial business purpose" for termination, insulating a plan from retroactive disqualification for lack of permanence. IRS TRAINING PROGRAM, *supra* note 12, § 3 at 458. Of course, the threat of retroactive disqualification is a powerful inducement to a comprehensive listing of all other factors leading to a plan termination, even though their importance relative to the impact of ERISA is slight. In fact, many employers may have simply omitted ERISA from their list of reasons for plan terminations. It is interesting to note that of 1,627 respondents to a recent House Committee on Small Business subcommittee questionnaire, 1,288, or almost 80 per cent, indicated that ERISA influenced their decision to terminate pension plans. 4 PENS. PLAN GUIDE (CCH) ¶25,194, at 27,366 (3d ed. 1977). It is also interesting to note that a survey of plan actuaries conducted last year indicates that 70 per cent of the actuaries who responded considered ERISA to be the major cause of increased plan terminations. BNA DAILY REPORT FOR EXECUTIVES at G-3 (Nov. 17, 1976).

[34] *Congressional Research Report*, *supra* note 33, at R-23 (evidence that terminations are occurring at 2.3 times the rate that could have been expected without ERISA and that the rate at which new plans have been adopted has dropped by approximately 50 per cent in 1975 and 1976); PBGC, ANNUAL REPORT 8-11 (1977) (10 per cent of PBGC-insured pension plans terminated in the first two years following enactment of ERISA and the rate of terminations is increasing). In July IRS Commissioner Kurtz announced that a preliminary survey of IRS regional offices showed that 30 per cent of the plans in existence when ERISA was enacted had terminated. BNA DAILY REPORT FOR EXECUTIVES at G-2 (July 20, 1977). Mr. Kurtz based his statement on data concerning IRS filings up until July 1, 1977. *Id.* Mr. Kurtz failed to take into account, however, the fact that many fiscal-year plans still had additional time in which to make the necessary ERISA amendments. Therefore, the 30 per cent figure is probably too high. Recent results from an IRS survey would indicate that this is the case. 163 PENS. REP. (BNA) A-5 (Nov. 14, 1977). (Responses from approximately half of the plans that IRS feared had terminated indicated 80 per cent still intended to adopt ERISA amendments).

[35] BNA DAILY REPORT FOR EXECUTIVES G-4, J-2 (Oct. 19, 1977); 159 PENS. REP. (BNA) A-43 (Oct. 17, 1977).

come both from those who have never enjoyed and, because of ERISA, never will enjoy coverage under a private plan and from those who were covered until ERISA came along. The large fund of private capital held by the private pension system has created jobs,[36] and those jobholders are taxpayers. Dampening or eliminating this source of capital cannot help but have a dampening effect on federal revenues.

THE OBJECTIVES OF TITLE II OF ERISA

If one is to believe that declarations of policy in legislation and in legislative history truly reflect legislative intent, then the objectives of Title II of ERISA may be summarized as follows:

(1) Illusory pension promises were declared to be contrary to public policy.[37]

(2) The tax expenditure involved in the private pension system was to be made more equitable by raising the allowable limits on deductions for contributions to H.R. 10 plans and by permitting the establishment of individual retirement accounts by those employed persons who were not covered by any form of private retirement plan.[38]

(3) The federal taxing power was to be protected.[39]

Pension promises were considered to be illusory for two reasons. Under some plans (notably multiemployer, negotiated, Taft-Hartley type plans), employees might have to spend most, if not all, of their lives in a particular industry or in a particular geographic area or else risk losing all rights to any form of pension.[40] A second reason for the illusory nature of some pension promises was the fact that they were only marginally funded.[41] Often this came about because it was expedient during collective bargaining to grant large increases in benefit

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[36] *Cf.* FUTURE OF PENSIONS, *supra* note 5, at 19-22.

[37] ERISA § 2(c), 29 U.S.C. § 1001(c) (policy to protect interests of participants by requiring vesting and funding of accrued benefits; S. REP. No. 93-127, 93d Cong., 1st Sess. 8-10 (1973).

[38] H.R. REP. No. 93-807, 93d Cong., 2d Sess. 11-12, 32-35 (1974); S. REP. No. 93-383, 93d Cong., 1st Sess. 13-14, 27-30 (1973).

[39] ERISA § 2(c), 29 U.S.C. § 1001(c) (policy of Act to protect the taxing power).

[40] The Teamsters' union plans typically required 20 years of service, plus a minimum of 50 years of age, before a union member became vested. Service could be lost while remaining in the same occupation if the member's new employer did not contribute to the same Teamsters' union plan or another plan having reciprocity with his or her first plan. *E.g.,* Teamsters Central States, Southeast and Southwest Areas Pension Fund, as in effect July 1, 1973, Art. I, §§ 14-15, and Art. II, § 16. These restrictive provisions have received widespread notoriety recently as a result of *Daniel v. Teamsters,* 410 F. Supp. 541 (N.D. Ill. 1976), *aff'd,* 561 F.2d 1223, 152 PENS. REP. (BNA) D-1 (7th Cir. 1977) (federal securities antifraud remedies applicable to pensions).

[41] *See* notes 23-25 and accompanying text.

levels without simultaneously increasing contributions to the required levels. Again, this was particularly true in the multiemployer, Taft-Hartley-type pension plans. It was also true in the much discussed Studebaker case.[42]

Increasing the deductible limits on H.R. 10 contributions was intended, in part, to halt the rush to incorporate, a practice especially prevalent among self-employed professionals.[43] That rush, in part, was fostered by the relatively low level of deductible contributions under H.R. 10 plans.[44] The IRA concept was adopted in recognition of the fact that some taxpayers were employees of employers who might never establish any form of qualified retirement plan.[45] The *quid pro quo* for all of this was the placing of limitations on contributions and benefits under *all* qualified plans.[46]

The third objective of Title II was to protect federal revenues. Committee reports are not helpful in determining what was intended by this declaration of policy. Was it intended to increase tax revenues by slowing the growth of the private pension system on the ground that the tax expenditure was too great? Was it intended to protect the federal revenue by placing limitations on contributions and benefits, while at the same time raising deductible contribution levels for the self-employed?

Turning to the first question, nowhere does the legislative history indicate an intent to dampen the growth and extension of the private system on the ground that the tax expenditure was too large. On the contrary, the committee reports from each of the four Congressional committees that brought ERISA into being state that its purpose was to increase the number of individuals participating in these plans.[47]

In reply to the second question, it is interesting to note that the combined net revenue loss due to raising the deductible limits for the self-

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[42] *See Private Welfare and Pension Plan Study, 1971: Hearings Before Subcomm. on Labor of Sen. Comm. on Labor and Public Welfare*, 92d Cong., 1st Sess. 208-14 (1971) (statement of Lester Fox).

[43] H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 4 (1974); S. Rep. No. 93-383, 93d Cong., 1st Sess. 4 (1973).

[44] Prior to ERISA, self-employed persons were limited to a $2,500 (or 10 per cent of earnings) maximum annual deduction, compared with the $7,500 (or 15 per cent of earnings) maximum permitted by ERISA. *Compare* 26 U.S.C. § 404(e)(1) *with* I.R.C. § 404(e)(1).

[45] H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 32-33 (1974); S. Rep. No. 93-383, 93d Cong., 1st Sess. 13, 27-28 (1973).

[46] H.R. Rep. No. 93-807, *supra* note 45, at 35-37; S. Rep. No. 93-383, *supra* note 45, at 29-30.

[47] H.R. Rep. No. 93-807, *supra* note 45, at 15 (House Ways and Means); 120 Cong. Rec. 3984 (1974) (House Labor); S. Rep. No. 93-383 *supra* note 45, at 19 (Senate Finance). *Cf.* S. Rep. No. 93-127, 93d Cong., 1st Sess. 18 (1973) (Senate Labor).

employed, while placing limitations on contributions and benefits under all plans, was estimated at $165 million.[48] This *net* revenue loss consisted of $175 million of estimated loss due to the increase in deductible limits for the self-employed and a revenue gain of only $10 million, as a result of the limitations placed on contributions and benefits.[49] In the context of budgeted federal receipts of approximately $265 billion for 1974,[50] a net revenue loss of $165 million (approximately .0006) can hardly be considered significant. It probably does not equal the annual cost overruns on at least one-half dozen government contracts. Even if the estimated net additional revenue loss of $355 million due to the provision for IRA's is taken into account,[51] the grand total net revenue loss of $520 million in the context of budgeted receipts of $265 billion would amount to a loss of only about .0019.

It is submitted that one of the basic objectives of ERISA (that is, the outlawing of illusory pension promises) represented a social goal. As such, it could well have been enacted as a part of some federal statute outside of the Internal Revenue Code. It is further submitted that the placing of limitations on contributions or benefits also represents a social goal and not a revenue protecting measure. Achievement of this goal, too, could have been accomplished in a federal statute outside of the Internal Revenue Code. Whether dollar limitations are a desirable way to achieve this social goal is open to question.

BROAD OUTLINE OF A RADICAL PROPOSAL TO SIMPLIFY THE INTERNAL REVENUE CODE WHILE ACHIEVING THE OBJECTIVES OF ERISA

In light of the stated objectives of ERISA, it is suggested that the Internal Revenue Code would be greatly simplified if the following could be achieved from a legislative and political standpoint:

(1) Amend the Internal Revenue Code to eliminate all of those provisions of Sections 401 to 415 that deal with qualification of a private retirement plan for purposes of the Internal Revenue Code.

(2) Simultaneously enact legislation declarative of public policy as embodied either in the sections of the Code deleted in accordance with (1), above, or in the declaration of policy relating to Title II of ERISA. This legislation (which might be called the Private Retirement Equity

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48 H.R. REP. No. 93-807, 93d Cong., 2d Sess. 41 (1974).
49 *Id.*
50 DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1976 at 229 (1976).
51 H.R. REP. No. 93-807, 93d Cong., 2d Sess. 41 (1974).

and Protection Act or PREP) would be declarative of public policy relating to:

(a) Nondiscrimination in contributions or benefits

(b) Vesting requirements

(c) Minimum participation standards

(d) Minimum funding standards

(e) Limitations on the amounts of tax expenditure that any individual, whether self-employed or an employee and whether covered under a qualified plan, may enjoy

(f) The extent (if any) to which transactions may take place between a qualified plan and a party-in-interest (that is, prohibited transactions).

(3) Amend Sections 402, 403, 404, and 501 to make clear that the tax treatment accorded to individual taxpayers, employers, and funding media would apply *only* if the requirements of PREP, as certified by a regulatory agency created to administer PREP, are met.

CERTAIN SPECIFIC PROPOSALS

Although this paper is primarily concerned with simplification of the Internal Revenue Code, one part of the assignment was to suggest how the major objectives of ERISA might be achieved with a small fraction of the effort now required. Success in any efforts directed toward that end might well have the collateral beneficial effect of slowing down, and perhaps even reversing, the trend toward termination of qualified plans.[52] Of necessity, this leads to policy questions that are considerably broader than the mere question of simplification of the Internal Revenue Code.

The mere transfer of certain provisions of the Code that are declarative of public policy might simplify the Code, but would eliminate none of the trauma that ERISA has caused. Unless that trauma is eliminated, the provisions in question might as well remain where they are. Therefore, in the course of adopting PREP, as suggested above, certain policy decisions also would have to be made. Among them would be the following:

(1) Fixed contribution–fixed benefit plans should be declared to be contrary to public policy.

(2) Where fixed contributions are made, individual employee accounts must be maintained.

[52] *See* notes 33-34, *supra*.

(3) Dollar limitations on benefits (other than the 100 per cent of final average pay limitation) should be eliminated for defined benefit plans. For defined contribution plans, a percentage limitation applicable to *earned* gross income or net earnings from self-employment (but no dollar limitations) should be specified.

(4) The "prohibited transaction" approach, which prevailed before ERISA, should be restored.

(5) A single, new agency should be created to enforce public policy, as embodied in PREP.

(6) Defined contribution plans should be exempt from the joint and survivor annuity requirements. Defined benefit plans should only be required to offer the qualified joint and survivor annuity as one optional method of benefit payment.

REASONS FOR SPECIFIC PROPOSALS

(1) Fixed contribution–fixed benefit retirement plans are contradictions in terms. They are a product of irresponsible conduct on the parts of both organized labor and management. Contributions have been kept lower than required, while benefits have been increased to levels not justified. This enables both parties to leave the bargaining table feeling satisfied. In the meantime, the funded status of employee benefits has deteriorated.

(2) For those employers or industries that desire to continue to provide fixed contributions, a requirement that individual accounts be maintained would protect the individual whose labors gave rise to the particular dollars contributed. Employees' interests in those accounts would have to become vested in the same way that they become vested in any other defined contribution plan.

If specific proposals (1) and (2) were adopted, the trauma that the "hours of service" concept has produced for plans with contributions and participation unrelated to specific hours worked would be eliminated. For plans that continue to base contributions on hours worked, the hours of service concept would continue to apply. As a practical matter, in these cases, a "percentage of pay" approach, coupled with individual accounts, probably could be adopted with the result that the "hours of service" concept could be eliminated. Think of the thousands of words defining an "hour of service" that could be eliminated from PREP regulations if this proved to be the case.

(3) The permissible deferral in a private retirement plan should not

depend upon whether one is self-employed or is employed by an employer who maintains a plan or by an employer who does not maintain a plan. Dollar limitations breed further inequity with increasing inflation. Percentage limitations are self-adjusting to both inflation and deflation. Certainly, dollar limits on contributions or benefits for the self-employed or for corporate employees who are covered by qualified plans cannot be justified on the grounds of protecting revenue. If the price of having IRA's is too high, then the answer is to calculate the revenue loss entailed by a policy decision that allows *all* individuals to enjoy whatever tax expenditure is involved and then to adjust all rates in all brackets to compensate for the revenue loss. Elimination of dollar ceilings on what the "boss" can obtain is almost certain to encourage more employers to establish plans and discourage other employers from terminating plans. The price of expanding coverage for the uncovered might well be the elimination of discrimination *against* higher paid individuals.

(4) The dual jurisdiction over prohibited transactions, coupled with the absolute prohibition of these transactions unless exempted by action of both the IRS and the Department of Labor, has proved completely unworkable.[53] The approval embodied in the pre-ERISA prohibited transaction provisions should be restored as a part of PREP. In effect, a transaction will be bad *unless* it provides adequate security and a reasonable rate of interest and so forth.[54] As evidenced by the flood of individual and class exemptions filed with the Department of Labor and the IRS, the effect of the approach taken in ERISA has been to prohibit many business transactions between employee trusts or insurance companies, on the one hand, and employers on the other hand, which were customary pre-ERISA transactions and rarely, if ever, jeopardized the security of the retirement funds involved. Of course, the remedy for prohibited transactions should continue to be a nondeductible excise tax, rather than disqualification.

(5) Pressure for a single regulatory agency continues to mount. In the meantime, both the IRS and the Department of Labor are faulted for delays in administering a law which, for all practical purposes, cannot

[53] A study of the Labor Department's handling of prohibited transaction exemptions highlights the difficulties of administering the ERISA prohibited transaction rules. Comptroller Gen., Efforts To Implement the Employee Retirement Income Security Act of 1974 by the Dep't of Labor: Report to the Sen. Comm. on Human Resources 13-15 (1977). This report stated that exemption applications have been on file for longer than two years with no final action. *Id.* at 13. The report also found that as of October 1, 1976, final action had been taken with respect to only 65 out of a total of 499 exemption applications. *Id.* at 14.

[54] 26 U.S.C. § 503.

be administered without undue administrative cost. Although both the Congressional committees and the executive agencies involved want to "protect their turf," the only practical answer would seem to be the creation of a new regulatory agency. In the last analysis, was ERISA enacted to preserve traditional "turf" for existing committees and agencies, or was it enacted to achieve its stated objectives? Which is more important?

(6) The qualified joint and survivor annuity requirements should not be applicable to defined contribution plans, since there is no possibility of a loss of a participant's account balances under such a plan solely by virtue of the participant's death. A participant's designated beneficiary would receive the participant's account balances if the participant died. The administration of defined benefit pension plans has been unduly complicated by the current rules requiring application of the joint and survivor method of payment unless a participant elects not to receive that method of payment. Administrative convenience, as well as plan simplicity, would be achieved if the presumption were exactly reversed and the qualified joint and survivor annuity would become payable only if the participant elected that method of payment.

CONCLUSION

The proposal made in this paper is radical. If the proposal is pursued by Congress, it is certain to raise howls of anguish from many quarters, including persons in government, some segments of organized labor, and some segments of industry. When a terminal illness is involved, radical surgery is often the only hope. It is not those persons in organized labor, government, or industry who are at death's door; it is the whole concept of a private pension system and the welfare of the millions of persons covered by it that are at stake. From a federal revenue standpoint, the needs of an aging population must be met. The only question is whether they will be met partially by social security and a private system or completely by social security or some other form of transfer payments.

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Tax Simplification for Small Business: Proprietorships, Partnerships, and Corporations—A Survey of Problem Areas

William P. Streng

DEFINING THE SMALL BUSINESS TAXPAYER SIMPLIFICATION PROBLEM

What Is a Small Business Taxpayer?

(1) Federal Income Tax Return Statistical Data.[1]

(a) ***Number of Business Income Tax Returns.*** The number and distribution of business income tax returns filed for the year 1970 were as follows:

	Number [in millions]	Per Cent
Partnership and proprietorships	10.33	86.0
Corporations	1.67	14.0
Subchapter S	.26	2.2
Other	1.41	11.8
Total	12.00	100.0

* William P. Streng is a Professor of Law at Southern Methodist University School of Law and is of counsel to Haynes & Boone, Dallas, Texas.

[1] In his 1975 testimony before the Senate Select Committee on Small Business, then Assistant Secretary of the Treasury, Frederic W. Hickman, provided much of this data in analyzing the question "What is a Small Business?" *See Hearings Before the Senate Select Comm. on Small Business,* 94th Cong., 1st Sess. 230 (1975) [hereinafter cited as *Hearings*]. The STATISTICS OF INCOME FOR 1972 CORPORATION INCOME TAX RETURNS, as

It will be noted that the predominant proportion of small business taxpayer returns are filed by proprietorships and partnerships (of which the majority is filed by proprietorships, as noted below).

(b) ***Number of Firms by Size of Receipts and Business Forms.*** The number of firms, by size of receipts and business form, for the year 1970 were as follows:

[In thousands]

Size of business receipts	Partner-ships	Proprietor-ships	Subchapter S corpora-tions	Other corporations
Under $25,000	502	7,247	58	394
$25,000 to $50,000	125	1,006	25	146
$50,000 to $100,000	120	661	40	180
$100,000 to $500,000	162	456	97	420
$500,000 to $1,000,000 ...	17	23	22	119
$1,000,000 to $5,000,000 ..	9	7	14	122
Over $5,000,000	1	.2	.8	27
Total	936	9,400	257	1,408

This table evidences the following:

(1) 77 per cent (7,247 of 9,400) of the proprietorships had business receipts under $25,000 (for the year 1970).

(2) A smaller but significant portion (53 per cent) of the partnerships had business receipts under $25,000.

(3) The median of gross receipts for corporations was around $100,-000.

(c) ***"Small Business" as Defined by Business Receipts.*** Total business receipts, by size and business form, for the year 1970 were as shown on the top of page 357.

If receipts of $500,000 or less are used to define "small business," then 20.3 per cent of the total business receipts were accounted for by small businesses. If the dividing line is $1,000,000 of business receipts, then "small business" accounted for 26.5 per cent of the total business receipts. If the dividing line is $5,000,000, the businesses included in

issued in March 1977, and the STATISTICS OF INCOME FOR 1974 BUSINESS INCOME TAX RETURNS (for sole proprietorships and partnerships), as issued in July 1977, include numbers of returns that are somewhat increased over the 1970 numbers; but the proportions would appear not to have materially changed.

[In millions of dollars]

Size of business receipts	Partnerships	Proprietorships	Subchapter S corporations	Other corporations
Under $25,000	3,290	43,830	391	1,715
$25,000 to $50,000	4,361	35,729	876	3,938
$50,000 to $100,000	8,436	46,278	2,886	11,160
$100,000 to $500,000	32,920	82,624	22,254	94,169
$500,000 to $1,000,000 ...	11,545	15,142	15,480	79,149
$1,000,000 to $5,000,000 ..	17,236	11,912	25,293	237,444
Over $5,000,000	12,420	2,211	8,287	1,117,213
Total	90,208	237,726	75,467	1,544,788

the small business group accounted for 31.5 per cent of the total business receipts.

(d) ***Percentile Approach To Defining "Small Business."*** [2] An arbitrary percentage of business firms might be classified as "small businesses." The percentage deemed appropriate for these purposes might be 90 or 95 per cent of all business. Classification might occur on the basis of number of employees, gross receipts, or other factors. An example of such an approach would be the following:

PERCENTAGES OF ECONOMIC ACTIVITY ACCOUNTED FOR BY SMALLEST 90 PER CENT OF ENTITIES 1967 ENTERPRISE STATISTICS [3]

Industry division	Percentage accounted for by smallest (measured by number of employees) 90 per cent of business entities			
	Employment	Payrolls	Value added	New capital outlays
All	15	11	NA	NA
Retail trade	26	22	NA	NA
Selected services	18	19	NA	NA
Construction	22	16	12	17
Manufacturing	13	12	12	5
Wholesale trade	44	43	NA	NA
Mineral	27	22	26	24
Miscellaneous transportation	44	41	NA	NA

Source: U.S. Department of Commerce, Bureau of the Census: "1967 Enterprise Statistics," pt. 1.

[2] This approach was suggested by then Assistant Secretary of the Treasury, Frederic W. Hickman, after he made the following observation:

Analysis of small business literature is complicated by the bewildering array of

Premised upon the multitude of statistics that have been presented in a variety of forms, it seems reasonable to conclude that, whatever test is utilized, at least 90 per cent of all business enterprises are perceived to be small businesses.

(2) The Small Business Administration's Definition of Small Business. The United States Small Business Administration (SBA) must rely on a definition of "small business" in order to perform its duties under its Congressional mandate. The SBA size standards are extremely complex and voluminous. Size standards have been established for approximately 880 industries.[4] Part II (entitled "What is a Small Business?") of the SBA's 1977 three-part study inconclusively discusses over 173 pages the question of what constitutes a small business.[5]

(3) Internal Revenue Code Definitions of "Small Business." No generally applicable definition of a "small business" exists within the four corners of the Internal Revenue Code. The criteria applicable to determining whether a "small business" exists include the following:

(a) ***Gross Receipts.*** Code Section 447(e), which requires the accrual

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definitions of "small business" that are used. Still worse, authors frequently fail to reveal, even in their footnotes, what definitions they are using. Unhappily, this is true of much of the testimony presented to your Committee. Even the Small Business Administration's report fails to indicate what definitions are being used. In fact, the Small Business Administration is charged with administering several different programs, and there are eight different purposes for which small business must be defined, with different definitions for each. They range in complexity from a simple statement that a small business is one which employs fewer than 500 persons to an extensive listing of industry categories with corresponding employment and/or sales criteria. Many of the definitions are very generous, and, in combination, these overlapping definitions would account for more than 99 per cent of all enterprises. One may question whether that is a useful definition of small business for analytic purposes. *Hearings, supra* note 1, at 231.

[3] An even more encompassing concept of small business was that presumably used by Senator McIntyre, who stated that small business accounts for 97 per cent of all business by number; 52-53 per cent of all private employment; 43 per cent of all business output; and about one third of the gross national product. *Statement at 1975 Small Business Hearings*, 94th Cong., 1st Sess. 711 (September 29, 1975). Similarly, in Senator Gaylord Nelson's October 26, 1977, Memorandum on Tax Reform Proposals presented to President Carter, Senator Nelson stated that 97 per cent of the 14 million business enterprises in the United States are small business enterprises and that the small business community accounts for 55 per cent of the jobs in the private labor force, 48 per cent of the business output, and 43 per cent of the gross national product.

[4] SMALL BUSINESS ADMINISTRATION, THE STUDY OF SMALL BUSINESS 45 (1977) [hereinafter cited as the SBA STUDY].

[5] In Part I of this study, however, it is noted that, in general, to qualify as a small business according to SBA size standards, a business concern (1) must be independently owned and operated, (2) must not be dominant in its field of operations, and (3) must have employees, annual receipts, assets, net worth, or net income (as applicable) that does not exceed a specified limitation. SBA STUDY, *supra* note 4, at 7.

method of accounting for certain corporate forms, provides that a small corporate form is one having gross receipts of $1,000,000 or less.

(b) ***Number of Owners.*** The Subchapter S (Small Business Corporation) election is available only to corporations having 10 (or 15) shareholders. Code Section 1371(a) and (e).

(c) ***Equity Capital.*** Code Section 1244 provides ordinary loss treatment on the sale or worthlessness of stock in a "small business." Such a small business is one where the equity capital does not exceed $1,000,000.

(d) ***Taxable Income.*** Code Section 11 provides for a "normal tax" of 20 per cent on the first $25,000 of taxable income, a "normal tax" of 22 per cent on the second $25,000 of taxable income, and a surtax of 26 per cent on amounts in excess of the $50,000 surtax exemption. This presumably contemplates that a small corporation is one whose taxable income is $50,000 or less.

(e) ***The Size of a Business Interest, as Compared with a Taxpayer's Other Assets.*** Code Section 303 provides for the treatment of a redemption as a capital gains transaction when the small business stock is redeemed to pay death taxes. Code Sections 6166 and 6166A provide for deferring estate tax payments for estates consisting largely of small business interests. To qualify for these provisions, the small business must constitute a specified portion of the decedent's gross estate.

What Are the Small Business Taxpayer's Tax Complexity Problems?

The problems evolving from the federal income tax system that must be confronted by the small business taxpayer are not unique, nor are they normally esoteric. They involve ordinary, commonplace questions confronted daily by the hundreds of thousands of small businesses. Since confronted by the small business, however, they may demand a greater proportion of time and administrative (non-income producing) effort with less expertise (and interest) brought to bear on the disposition of those matters. Economies of scale for handling these matters are not available for the small business. Accounting matters, for example, may necessitate hand-written journal entries and billing procedures, not computer-generated billing, inventory control, cash flow, and income statements.

In general, the tax problems of the small business can be approached from two perspectives: [6]

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[6] According to the SBA STUDY, *supra* note 4, at 5, the federal tax system creates a bias against small business because of the difficulties encountered in understanding and com-

(1) The complexity of the tax return filing and other documentation requirements.

(2) The complexity of the substantive taxing system itself, which imposes upon the small business taxpayer literally hundreds of decisions concerning what is income, what are deductions, when do those items of income or deductions arise, and the categorization of income items as ordinary or capital gain. This is complicated by the hundreds of alternatives that are available to the taxpayer through the making of appropriate elections.

Many of the Code provisions dealing specifically with small business tax liabilities have been catalogued below. Some of these concepts may be much more relevant to questions of substantive tax policy than to tax simplification-complexity issues. Of course, in many specific cases, the question of where "small business simplification" terminates and substantive tax relief commences can be raised. In many instances, these issues are irrevocably intertwined.

SPECIFIC SMALL BUSINESS TAXPAYER STRUCTURAL–SUBSTANTIVE CONSIDERATIONS

Legal Form of the Business

The small business can function under local law in sole proprietorship, partnership, or corporate form. As noted in the discussion below with respect to tax forms, the legal format of such organization will control the type of federal income tax return to be filed. If organized as a sole proprietorship, the taxpayer's business income is combined with his nonbusiness income on the Form 1040. The tax is then imposed at the applicable individual rates, which are graduated from 14 per cent to 70 per cent.

If the small business is operated through a partnership, that partnership is not a taxable entity separate from its partners. The partnership's income, losses, and other tax characteristics pass through to the individual partners and are included in their individual tax returns (Form 1040). Operating income or loss, however, is calculated at the partnership level. And, the partnership itself may make many important tax elections.

plying with its complexities, such bias being compounded by (1) the multiplicity of taxes at the federal, state, and local levels; (2) the burden of reporting and paying payroll taxes; (3) the difficulty of estimating income and paying taxes in advance; (4) the lack of educational opportunities in the area of taxation; and (5) the expense and inadequacy of professional tax assistance.

If the small business is organized in corporate form, that corporation will be a separate taxable entity. The income will be taxed to the corporation when earned (as reported on the Form 1120) and will again be taxed to the shareholders at their individual rates when distributed in the form of cash or other property. Partial relief from this double taxation is provided upon receipt of dividend distributions by individuals (the dividends-received exclusion under Code Section 116) and by corporations (the dividends-received deduction under Code Section 243). When the corporate tax rates are less than the shareholder's marginal rates, tax deferral can be accomplished through the use of a corporation.[7] The business owners then hope that eventual distributions of the corporation's earnings and profits will be only subject to tax at the reduced capital gains rates.

The corporate tax can also be circumvented through the use of the small business (Subchapter S) election. Under these circumstances, although the legal form is corporate (thereby enabling the limitation of liability), the tax treatment is essentially similar to partnership tax reporting.

The SBA has suggested that a small business (whether in sole proprietorship, partnership, or corporate form) should be categorized as an entirely different taxable entity from the large taxpayer (whether a large corporation or a substantial tax-shelter partnership with the partnership interests being widely distributed through an underwriting syndicate). This would be similar to the situation in many foreign countries, where a "limited liability company" is permitted to be organized. These entities often have both partnership and corporate characteristics.[8] In most instances, a limit is imposed on the maximum number of equity owners.[9]

Specifically, the SBA has proposed the creation of a new tax-paying entity called a "small business enterprise" (SBE), defined in terms of the number and nature of its equity owners, its capitalization, and its gross profit.[10] The SBE would be taxed in a manner similar to an unincorporated business, but would have some tax characteristics of a corporation. The legal form of business organization would be ignored.[11]

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7 The accumulated earnings tax (I.R.C. §§ 531-537) and the personal holding company tax (I.R.C. §§ 541-597) function to establish some restraints on the use of corporations as accumulation vehicles.

8 *See* Internal Revenue Manual (CCH), Exhibit 600-8 at 7285-20 for a list showing how the Internal Revenue Service categorizes these entities for income tax purposes.

9 *See* the chart in the SBA Study, *supra* note 4, Part III, following p. 50.

10 SBA Study, *supra* note 4, Part III, at vii.

11 Presumably, where a closely held corporation is involved the idea would be to provide a tax option permitting the owners of the corporation to be taxed as partners in a partnership. This would be similar to the Subchapter S treatment now available.

The adoption of any such "small business enterprise" concept would necessitate a structure in the Internal Revenue Code similar to that of Subchapter S. Unlike the situation in most foreign jurisdictions, the establishment of legal entities and the imposition of a national taxing system are not under the authority of the same governmental unit. States, not the federal government, provide the rules with respect to the creation of legal entities.

Proponents of an SBE concept argue that, under this format, the discrimination against the unincorporated business would be eliminated. For example, discrimination with respect to the establishment of retirement plans, whether a Section 401 plan or an H.R. 10 plan, would be eliminated. Other items, however, that would need to be considered in creating a "small business enterprise" tax entity and for which precise rules would need to be provided include:

(1) Gain or loss recognition (if any) for capital contributions

(2) The tax basis of the equity owner's interest

(3) The tax basis of contributed property in the hands of the small business enterprise

(4) Special allocations (if any) allowable among equity owners

(5) The computation of the operating income of the small business enterprise

(6) Types of permissible income (for example, active versus passive sources)

(7) Allocation of profits, salaries, and interest to equity owners

(8) Flow-through (if any) of items of income, deduction, and credit

(9) Transactions between the entity and its equity owners

(10) Distribution of money or property to the equity owner

(11) Tax basis of property distributed to the equity owner

(12) Treatment of liabilities

(13) Distribution to an equity owner of property subject to a liability

(14) Liquidation of the small business enterprise

(15) Sale or exchange of the equity interest in the small business enterprise

(16) Accounting methods

(17) Available taxable years

(18) Transitional rules.

The ultimate question to be asked in this context is whether a fundamental disruption of the present system through implementation of the SBE concept would exacerbate the complexity problem. This may very well be the result.

Tax Rates Applicable to Small Business

The present tax rate structure provides for a 20 per cent rate on the first $25,000 of a corporation's taxable income, a 22 per cent rate on the second $25,000 of a corporation's taxable income, and a 48 per cent rate on taxable income above that level. In the context of small business relief, it is often suggested that smaller business taxpayers organized in corporate form pay a higher average tax than do large corporate taxpayers. If so, should this rate structure be modified? Specifically, should the corporate rate be graduated? Certainly, this issue is not precisely one of "simplification." This question is, however, integrally related to the question of the equitable distribution of tax burden. Varying proposals have been made to distribute the tax burden differently.

(1) Proposals for Rate Structure Changes.

(a) ***National Federation of Independent Business.*** In the 1975 tax reform proposals dealing with this subject, the National Federation of Independent Business suggested that the rate structure be graduated in the following manner: [12]

TAXABLE INCOME			TAX RATE	
$ —0—	to	9,999	10 per cent	
10,000	to	19,999	$ 1,000 plus 15 per cent of excess over	$ 10,000
20,000	to	29,999	2,500 plus 20 per cent of excess over	20,000
30,000	to	39,999	4,500 plus 25 per cent of excess over	30,000
40,000	to	49,999	7,000 plus 30 per cent of excess over	40,000
50,000	to	59,999	10,000 plus 35 per cent of excess over	50,000
60,000	to	69,999	13,500 plus 40 per cent of excess over	60,000
70,000	to	499,999	17,500 plus 45 per cent of excess over	70,000
500,000	and over		211,000 plus 50 per cent of excess over	500,000

In supporting its argument in favor of this proposal, the Federation of Independent Business observed that, based on 1970 income statistics, 600,000 (or 82 per cent) of the corporations paying income taxes that year had taxable income of less than $30,000. The Federation argued that: 1) small corporations need more working capital and (2) a

[12] *See* SMALL BUSINESS TAX REFORM, JOINT HEARINGS at 1151 (1975).

graduated corporate income tax would bring corporate taxation into greater conformity with the principle of the ability to pay.

(b) ***Treasury Department's Small Business Advisory Committee.*** In the December 1976 report of recommendations of the U.S. Treasury Department's Small Business Advisory Committee, it was suggested that the corporate tax rate structure be graduated as follows: [13]

TAXABLE INCOME	TAX RATE
$ —0— to 9,999	—0—
10,000 to 49,999	12.5 per cent
50,000 to 199,999	25.0 per cent
200,000 and over	48.0 per cent

Under this proposal, the 25 per cent bracket would be reached at a higher level of taxable income ($50,000) than under the National Federation of Independent Business proposal. The top bracket level under this proposal (48 per cent on taxable income over $200,000), however, would be reached much earlier than under the National Federation of Independent Business proposal (50 per cent on taxable income above $500,000).

(c) ***Treasury Department's Option Paper.*** In its September 2, 1977, *Tax Reform Option Paper No. IX, Business Tax Reductions,* the Treasury Department recommended that the corporate tax rate for taxable income over the amount of $50,000 be reduced by two percentage points, from 48 per cent to 46 per cent. In addition, the 20 per cent rate on the first $25,000 of taxable income would be reduced by one percentage point to 19 per cent, and the 22 per cent rate on income between $25,000 and $50,000 would be reduced to 21 per cent. Since one of the two percentage points under this proposal would relate to the normal tax (rather than the surtax), this would be a tax reduction that would be particularly beneficial to small business. In assembling the arguments concerning these small business taxpayer proposals, the Treasury noted in its *Option Paper* that many small business taxpayer groups will support a fully graduated corporate income tax, under which both percentage points would be used to reduce the normal tax.[14]

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[13] *See* SENATE SELECT COMM. ON SMALL BUSINESS, 27TH ANNUAL REPORT, S. REP. NO. 95-30, 95th Cong., 1st Sess. 204 (1977).

[14] Subsequently, on January 21, 1978, in his tax change proposals as sent to the Congress, President Carter suggested that effective October 1, 1978, the first two rate brackets be reduced to 45 per cent on taxable income in excess of $50,000. In addition, the top rate would be reduced an additional point, to 44 per cent, on January 1, 1980.

(2) Are Small Businesses Victims of Effective Tax Rate Discrimination? The description of rate structure alternatives, discussed above, is important in confronting the tax equity argument that the relative tax burden on the small business is larger than the tax burden on the large business. This argument has been propounded by a number of small business taxpayer proponents.[15]

In his testimony in the 1975 Hearings, then Assistant Secretary of the Treasury, Frederic Hickman, confronted this question. He provided the following chart indicating the distribution of taxes on incomes of businesses, based on size of business receipts and business form.[16]

TAXES ON INCOMES OF BUSINESSES, BY SIZE OF BUSINESS RECEIPTS AND BUSINESS FORM, 1971
[In millions of dollars]

Size of business receipts	All returns	Sole proprietorships	Partnerships	Subchapter S corporations	Other corporations
All "small" businesses [1] . . .	7,607	4,137	701	151	2,618
Under $25,000	850	726	17	([2])	107
$25,000 to $50,000	1,060	905	41	([2])	114
$50,000 to $100,000	1,443	1,119	101	5	218
$100,000 to $500,000	2,953	1,277	427	83	1,166
$500,000 to $1,000,000 . . .	1,301	110	117	61	1,013
"Large" businesses [1]	28,333	89	443	198	27,603
Total	35,940	4,226	1,144	349	30,221

[1] The "small" consist of those businesses with business receipts of less than $1,000,000, and the "large" consist of those with business receipts of $1,000,000 or more.
[2] Not available.

Mr. Hickman noted that of the $36 billion of income taxes estimated to have been paid by United States businesses during the period in

[15] *See* the statement of Senator Gaylord Nelson, Chairman, Senate Select Committee on Small Business, before the Select Committee on Small Business and the Subcommittee on Financial Markets of the Committee on Finance, U.S. Senate, June 17, 1975:

> Although the statutory maximum corporate rate is 48 per cent, one out of every five big companies pays less than 43 per cent and the largest 100 corporations consistently pay between 25 per cent and 30 per cent. In contrast, smaller companies trying to grow so as to be effective competitors must often pay the full statutory rate of 48 percent.

See also Senator Nelson's October 26, 1977, Memorandum on Tax Reform Proposals to President Carter; SENATE SELECT COMM. ON SMALL BUSINESS, 26TH ANNUAL REPORT, 94th Cong., 2d Sess. 85-88 (1976); and SENATE SELECT COMM. ON SMALL BUSINESS, 27TH ANNUAL REPORT, 95th Cong., 1st Sess. 59 (1977), which indicate that the committee and the U.S. Treasury Department are studying the extent to which differences in effective tax rates occur with respect to businesses of different sizes.

[16] *Hearings, supra* note 1, at 235.

which this chart is applicable, $30 billion was paid by corporations other than Subchapter S corporations. The remaining $6 billion was paid by sole proprietorships, partnerships, and Subchapter S corporations. Businesses with receipts of less than one million dollars produced about 21 per cent of the business taxes. These businesses accounted for most of the taxes paid by unincorporated businesses but less than one half of the taxes paid by Subchapter S corporations and only 9 per cent of the taxes paid by other corporations.

Mr. Hickman testified that under the existing system small businesses do not pay more taxes than larger businesses, but rather pay substantially less. There are two reasons for this. First, since most small businesses are unincorporated, their profits are subject to tax only at the individual level, in contrast with corporate income, which is taxed at both the corporate and the individual levels. Integration of the corporate and individual income taxes would, of course, change this distribution load. Second, one half of all corporations have no income subject to tax. This is attributable either to: (a) the payment of income to owner-managers in the form of deductible compensation or (b) the tax-option election by the corporation under Subchapter S.

The following chart supports the Treasury Department's perspective (as of the time of Mr. Hickman's testimony) on the corporate income tax for all corporations:

THE PROGRESSIVITY OF THE CORPORATION INCOME TAX FOR SMALL CORPORATIONS

	Effective rate of tax (per cent) [2]
Corporation income class [1]:	
$0 to $25,000	20.4
$25,000 to $50,000	27.5
$50,000 to $100,000	36.6
$100,000 to $250,000	41.7
$250,000 to $1,000,000	44.2
$1,000,000 or over	44.4
All returns with income subject to tax	42.0

[1] Corporations are classified by amount of income subject to tax at normal tax and surtax rates.

[2] Total tax divided by total income. "Tax" is liability after the investment credit, but before the foreign tax credit. "Income" is income subject to tax (including alternative tax), after the net operating loss and dividend deductions.

Diversity of opinion obviously exists with respect to the distribution of the tax load between large and small corporations.

Complexity of the Subchapter S Rules

If the small business is organized in corporate form, it may be eligible for and may make a Subchapter S election. Subchapter S was initiated to enable taxpayers to utilize the corporate form for limiting potential liability but also to avoid the double level of corporate and shareholder taxation.[17] This is accomplished by having the corporation income taxed directly to shareholders, whether or not distributed, and consequently no tax is imposed at the corporate level.[18]

The extreme complexity of the Subchapter S provisions, as they have evolved, however, has often caused this form of elective business taxation to be characterized as a trap for the unwary.[19] This can be observed from the very technical nature of the Subchapter S amendments included in the Tax Reform Act of 1976:

(1) Act Section 902(a) increases the permissible number of Subchapter S shareholders from 10 to 15 after five years or if the additional shareholders acquire an interest through inheritance.

(2) Act Section 902(b) allows previously taxed income of a Subchapter S corporation to be distributed tax free, even though accelerated depreciation may have produced undistributed earnings and profits for the corporation.

(3) Act Section 902(c) eliminates the estate of a deceased shareholder as a possible additional disqualifying shareholder.

(4) Act Section 902(c) permits a grantor trust, voting trust, or other trust used for estate planning to hold Subchapter S stock, without nullifying the Subchapter S election.

(5) Act Section 902(c) enables the termination of Subchapter S corporate status to be avoided when a new shareholder inadvertently refuses to consent to this form of organization.

Notwithstanding the changes implemented under the Tax Reform Act of 1976, tax management of the Subchapter S corporation is still fraught with difficulties. The Treasury Department's recommendation

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17 In 1972 more than 280,000 (about 28 per cent of the U.S. corporations with total assets of less than $1 million) elected to be taxed under the Subchapter S provisions. Statement by Gerald Sherman, SMALL BUSINESS TAX REFORM, JOINT HEARINGS 1319 (1975).

18 Subchapter S was first enacted in the Technical Amendments Act of 1958 (Pub. L. No. 85-866, 85th Cong., 2d Sess. § 64(a)). This evolved out of a report by the Senate Select Committee on Small Business (S. REP. NO. 1237, TAX PROBLEMS OF SMALL BUSINESS (1958), which, in turn, had generated a small business tax adjustment bill.

19 The SBA STUDY, *supra* note 4, at 22, states: "Complexities and pitfalls of Subchapter S have caused this provision to fail in its stated purpose of removing tax considerations in the formation of a small business."

would remedy this only to a limited extent. In its September 2, 1977, *Tax Reform Option Paper No. IX, Business Tax Reductions*, the Treasury Department suggests that the Subchapter S limits be further eased in several respects. It suggests that one of the more important changes would be the repeal of the passive income test for a Subchapter S corporation. This would eliminate the rule that corporations may not obtain more than 20 per cent of their receipts from passive investment sources, such as dividends and rents. More fundamental revision is necessary, however, to return Subchapter S to its original purposes.

Small Business Stock

(1) **Losses.** Code Section 1244 currently provides that if "Section 1244 stock" is sold at a loss, the loss will be ordinary loss. The corporation issuing such stock must be a "small business corporation." To be a small business corporation, no more than $500,000 of "small business stock" can be offered and the aggregate corporate capital cannot exceed $1,000,000.[20] The stock must be issued pursuant to a special plan.

Only taxpayers who are individuals are entitled to the benefit of Code Section 1244. The maximum amount of losses that can receive ordinary loss treatment in any one year is $25,000 ($50,000 for married individuals filing jointly).

The process of qualifying "Section 1244 stock" as such is relatively simple and straightforward. It must be accomplished expeditiously during the organizational phase. This will, however, often necessitate the utilization of an attorney's services and, to this extent, complexity is encountered.

(2) **Gains—Venture Capital Rule.** Under current law, one half of a long-term capital gain is included in an individual's tax base (making the effective tax rate range from 7 per cent to 35 per cent). Under the alternative tax, the first $50,000 of these gains is not taxed at over 25 per cent. Long-term capital gains of corporations are taxed at 30 per cent. The untaxed portion of the capital gains is included in the base of the minimum tax.

In its *Tax Reform Option Paper No. III, Capital Gains and Losses*, the Treasury Department suggested that realized capital gains be taxed as ordinary income. To ameliorate the effect of inflation, the Treasury

[20] President Carter's January 1978 tax change proposals include increasing this $500,000 amount to $1,000,000.

Department has suggested a limited tax basis increase through indexation. In addition, a "venture capital rule" is proposed, whereby the gain on the sale of "venture capital stock" held for 10 years or more (or transferred at death) would be taxed at a rate that approximates the maximum regular and minimum tax rate on capital gain under current law.

Pursuant to this rule, a credit against the tax equal to 10 per cent of the gain would be provided. This treatment would apply to the first $1 million of stock issued by newly formed, unaffiliated corporations engaged in manufacturing, research, or extraction. The stock would be only that issued in the first five years of the corporation's existence at a time when the stock was not publicly traded. Stock issued under Code Section 1244 prior to the effective date of this proposal would qualify for venture capital treatment.

The arguments assembled by the Treasury in support of this proposal are: (a) this special treatment will defuse much of the objection concerning injury to venture capital as a result of removing capital gains treatment and (b) although investors in small corporations already receive ordinary loss treatment to some extent under present law, the allowance of ordinary loss treatment is not a compensating benefit for the full taxation of gain. The opposing argument made by the Treasury Department is that allowing one exception to full taxation of capital gain will encourage other claims to similar special treatment and regenerate the complexities that plague the current capital gains structure.

If the current Code Section 1244 dealing with losses is deemed to constitute "tax complexity," then the gains side would seem to double that complexity if the proposed venture capital rule were to be adopted. Of course, such complexity may be acceptable in view of the objectives sought.

The Accumulated Earnings Tax—Permissible Accumulations

Under Code Section 531, a penalty tax is imposed, in addition to the regular income tax, at rates varying from 27½ per cent to 38½ per cent. The tax is imposed on a corporation that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation by permitting the earnings and profits to accumulate instead of being divided or distributed." The large, publicly held corporation is normally not subject to this tax.[21]

[21] *But see* Golconda Mining Corp. v. Commissioner, 507 F.2d 594 (9th Cir. 1974).

Rather, this penalty tax is typically imposed on the small business organized in corporate form. The objective of the tax is to ensure that the actively conducted corporation (as distinguished from the personal holding company) is not using its corporate form to shelter income from a higher marginal tax rate that would be applicable to that income in the hands of the individual shareholder(s).

The Code Section 531 tax is computed on federal taxable income after reduction for any dividends-paid deduction and after adjustments for certain items, including an allowance for federal corporate income taxes and for the "accumulated earnings credit." This latter credit begins with a minimum credit of $150,000, which is deemed retained for the "reasonable needs of the business." Accumulations in excess of that amount create a presumption of unreasonableness and impose a burden on the taxpayer to prove otherwise.

In its September 2, 1977, *Tax Reform Option Paper No. IX, Business Tax Reductions,* the Treasury Department proposed that the accumulated earnings tax be eased so that a corporation that has reached the $150,000 ceiling would still have a safe haven. That safe haven treatment would be applicable annually to no more than 25 per cent of its current profits.[22] This concept, as now proposed by the Treasury, would not appear to enable simplification of the Code Section 531 provisions.

Deferred Compensation

The problems of complexity for a small business taxpayer are particularly apparent in the context of deferred pay planning, especially due to the applicability of the ERISA legislation. This is a separate subject covered in-depth in the paper prepared by John R. Lindquist, "Simplification for Business Taxpayers: ERISA—Was All This Really Necessary?" on page 341 of this Appendix.

TAX ACCOUNTING (TIMING) CONSIDERATIONS

Cash Versus Accrual Method

If inventories are an income-producing factor, a business must determine its taxable income under the accrual method of accounting. Under

[22] In addition, the U.S. Treasury Department's Small Business Advisory Committee earlier suggested that (1) the accumulated earnings ceiling be $500,000, rather than $150,000 and (2) the implementing Treasury regulations "state clearly what will be considered to be an unreasonable accumulation." *See* Senate Select Comm. on Small

the accrual basis, accounts receivable are included in income and accounts payable are treated as deductible expenses if all events have occurred to fix the liability and the increase in inventory during the year is excluded from the cost of sales.

For the small business, the cash method is much easier to apply, although the accrual method probably measures economic income more accurately. Some have suggested that, for the purpose of simplification, the cash method might be made available (on an optional basis) for those taxpayers having a closing inventory of less than a specified value (for example, $500,000) or below a specified level of gross receipts ($1-2 million).[23] If adopted, to take account of inflationary cycles, this eligibility level might annually be adjusted (perhaps, through reference to some economic indicator index). The analytical argument in support of the cash method is that the taxpayer's income would be accurately reflected over an extended time span (although not during the year of any change to the cash method).

If implemented, transitional rules would need to be adopted for (1) the business that is currently on the accrual method but would become eligible for the cash method when this option would become available and (2) those business taxpayers utilizing the cash method under this new approach but which thereafter are required to use the accrual method because their inventory level exceeds the level permitted for cash basis method eligibility. Presumably, these problems could be solved through suspense accounts, spreading the adjustment amount forward (for example, over a 10-year period) and other transitional devices.

The cash method of accounting is presently available for one type of small business, the family farm. Prior to the Tax Reform Act of 1976, the cash method was available to farming enterprises, whether in proprietorship, partnership, or corporate form, without regard to the magnitude of operations. This contributed to the growth of tax shelter farming investment syndicates. In Code Section 447, as enacted in the Tax Reform Act of 1976, a corporation engaged in farming is now required to compute its taxable income on the basis of the accrual method of accounting. An exception from this requirement is provided,

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BUSINESS, 27TH ANNUAL REPORT, S. REP. NO. 95-30, 95th Cong., 1st Sess. 205 (1977). Were this proposal to be implemented, no greater complexity would appear to result. Many more corporations, however, would be immune from the § 531 tax; and tax equity would thereby be frustrated.

[23] In Attachment I to Senator Gaylord Nelson's October 26, 1977, Memorandum on Tax Reform Proposals to President Carter, the observation was made that "it is understood that the Internal Revenue Service does not object to such a proposal [to permit the use of the cash method to small businesses having inventories]."

however, under Code Section 447(c) for "small business and family corporations." These corporations can include (a) a Subchapter S corporation, (b) a corporation of which at least 50 per cent of the total combined voting power of all classes of stock entitled to vote and at least 50 per cent of the total number of shares of all other classes of stock of the corporation are owned by members of the same family, and (c) a corporation having gross receipts of $1,000,000 or less. Thus if the cause of simplicity would be deemed to be served by making available the cash method of accounting to the smaller business taxpayer, precedent exists in the farming business context for so doing and for differentiating between small and large taxpayers with respect to the use of the cash method. In the last analysis, however, the cash method, under these circumstances, does not clearly reflect income.

Inventory Method

Various groups have suggested that a streamlined, less complicated Last-In First-Out (LIFO) method of inventory identification should be provided for small businesses. Under the LIFO method, the goods deemed sold for tax purposes are those that have most recently gone into the inventory. Such an identification method has no relevance to the actual goods that are disbursed from inventory.

When prices are rising (as was particularly evidenced during the double digit inflation of 1973), the taxpayer is advantaged by designating the most expensive (and usually the most recently produced) goods as those sold. Since the cost of goods sold is thereby increased, the gross income is thereby decreased (gross receipts less cost of goods sold equals gross income).

Substantial recordkeeping procedures are imposed when the LIFO inventory method is used. The older and less costly produced goods are deemed to be retained in inventory pools. Careful records must be kept to document the historic costs of each "LIFO pool."

The complexity to the small business of continuing to identify LIFO pools for many prior years (particularly when over those years the physical inventory may have significantly increased) might be partially eliminated through averaging mechanisms. For example, 5 years, 10 years, or the total business existence time might be regarded as an appropriate period over which to identify inventory costs under the LIFO identification method.

Depreciation Policies

(1) Immediate Capital Cost Recovery. Depreciation issues are one of the biggest sources for disputes between small business taxpayers and the Internal Revenue Service. The easiest method to dispose of depreciation controversies would be to allow an immediate deduction (in the year of acquisition) of the acquisition cost. Some European tax systems permit immediate capital cost recovery or such recovery over a limited two- or three-year period after acquisition. Under these circumstances, the measurement of the annual allowance of depreciation by reference to the useful life of the asset or to economic obsolescence is no longer relevant.

Such immediate capital cost recovery would cause very substantial revenue losses and would need to be limited to some maximum annual amount. The Treasury Department's Small Business Advisory Committee has suggested a limitation of $200,000 a year with respect to eligible personal property and a limitation of $200,000 a year in the case of real estate.[24]

(2) Useful Lives. A substantial number of complaints have been registered concerning the complexity of the Asset Depreciation Range (ADR) regulations.[25] Revenue Procedure 62-21, as altered by Code Section 167 (m) and the ADR regulations, provides for the classification of assets for the purpose of establishing a useful life for these several assets. Even the Treasury Department has recognized that the complexity of the ADR system has made it unattractive for small business.[26]

If the concept of immediate capital cost recovery is rejected, then the establishment of useful lives might be made more simple than is now the case under the ADR regulations. For example, the cost of all depreciable personal property could be made recoverable over five years. The cost of all depreciable real property could be made recoverable over ten years.[27] Vintage accounts might be established for each year.

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24 SENATE SELECT COMM. ON SMALL BUSINESS, 27TH ANNUAL REPORT, S. REP. NO. 95-30, 95th Cong., 1st Sess. 203 (1977).

25 In Senator Gaylord Nelson's October 26, 1977, Memorandum on Tax Reform Proposals presented to President Carter, Senator Nelson indicated that the ADR system is used by 63 per cent of the businesses with $1 billion in assets, by 33.5 per cent of the firms with over $100 million in assets, and by .9 per cent of the businesses with under $500,000 in assets.

26 DEPARTMENT OF THE TREASURY, BUSINESS TAX REDUCTIONS (TAX REFORM OPTION PAPER NO. IX) (1977).

27 The concept of depreciation schedules permitting cost recovery in 5 and 10 years, respectively, for equipment and buildings was included in The Capital Recovery Act of 1975, H.R. 7543, 94th Cong., 1st Sess., as introduced by Representative Waggoner (D. La.) and Representatve Archer (R. Tex.).

If more detailed asset groupings are desired for this purpose, the following classification might be used:

(a) Depreciable real estate

(b) Machinery and equipment

(c) Furniture and fixtures

(d) Transportation equipment

(e) Other

Whatever approach is utilized, the underlying concept would be that the useful life of an asset has been legislated and that this useful life does not necessarily have any direct relevance to its actual useful life. Of course, care would need to be exercised to precisely describe the types of assets included in each category to avoid characterization disputes (such as have occurred in attempting for investment credit purposes to have properties categorized as "Section 38 property").[28]

(3) Salvage Value. The establishment of an appropriate amount of salvage value has been the source of many tax audit controversies. Periodic attempts have been made to eliminate this as a continuing tax issue. For example, Code Section 167 (f) provides that in computing salvage value the taxpayer may reduce the amount taken into account as salvage value by an amount that does not exceed 10 per cent of the basis of the property. Likewise, the ADR regulations contain special provisions for the treatment of salvage value. Treasury Regulation Section 1.167 (a)-11 (d) provides that, as provided in Code Section 167 (f), a taxpayer may reduce the amount of gross salvage value of a vintage account that does not exceed 10 per cent of the unadjusted basis of the personal property in the account.

In its September 2, 1977, *Tax Reform Option Paper No. IX, Business Tax Reductions,* the Treasury Department proposes the elimination of salvage value for small business taxpayers. This would eliminate the cause of audit disputes, which continue to exist notwithstanding the provisions described above, for many small business taxpayers.

(4) Depreciation Methods. Under Code Section 167(b), the small business taxpayer may be faced with a choice between straight-line, double-declining balance, 150 per cent declining balance, or a sum-of-the-years digits method. Other more intricate methods are also available, such as the flow of income method and the units of production

[28] In his January 1978 tax revision proposals, President Carter suggested that the ADR system be simplified and that a table of useful equipment lives be adopted.

method. These alternative methods force the small business taxpayer to make a difficult decision. The straight-line method is the easiest to compute, but provides the least immediate tax benefits. The accelerated methods provide greater immediate tax savings, at the cost of more difficult recordkeeping.

In its September 2, 1977, *Tax Reform Option Paper No. IX, Business Tax Reductions,* the Treasury Department proposes requiring small businesses to use straight-line depreciation if they do not elect ADR. Thus the small business taxpayers (most of whom would probably not use ADR) would effectively be required to use the straight-line method. Simplification could result through implementation of this proposal. If combined with shortened useful lives, any adverse financial impact could be eliminated.

(5) **First-Year Conventions.** During the first year that an asset is placed into service, a computation will need to be made that allocates depreciation to that portion of the year during which that asset was in service. This will necessitate an allocation based on actual days or months of use.

A taxpayer may opt to use a "modified half-year convention," under which assets placed in service during the first half of the taxable year are deemed to have been acquired as of the first day of the taxable year and assets placed in service during the second half of the taxable year are treated as placed in service on the first day of the next taxable year.[29]

(6) **Capitalization Versus Expense Requirement.** Under the current system, the cost of any asset acquired that has a useful life beyond the current tax year should be capitalized, no matter how minimal that cost. Assuming that no immediate capital cost recovery system is to be implemented, a "capitalization minimum" might be implemented, whereby items having a unit price of less than a specified dollar amount (for example, $1,000) could be expensed. This would be permitted,

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[29] As part of the original ADR regulations a three-quarter year convention was proposed, whereby all assets placed into service during the first one half of the tax year would (assuming a calendar year) be deemed placed into service on January 1 and the assets placed into service during the second one half of the year would be deemed to have been placed into service on July 1. Under this first year convention, nine months of depreciation would be available for assets placed in service during each year (on the assumption that an equal value of assets are placed into service during the first one half and the last one half of the year). In I.R.C. § 167(m)(2), however, the available convention was limited to a one-half year convention, specifically providing:

> No convention with respect to the time at which assets are deemed placed in service shall be permitted under this section which generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

notwithstanding the fact that the items have usefulness beyond the current year. It is understood that such a rule may already be informally applied by IRS representatives in large taxpayer audits, particularly where another federal agency (for example, the Interstate Commerce Commission, which prescribes regulatory accounting procedures for railroads) requires small unit expenditures for capital items to be currently expensed.

(7) First-Year Depreciation—Code Section 179. In addition to the annual depreciation allowed under Code Section 167, Code Section 179 permits an additional first-year deduction of 20 per cent of the cost of property having a useful life of at least six years. This "bonus" depreciation deduction is limited to $2,000 (20 per cent of $10,000 cost) for any year. The taxpayer is required to maintain records specifically identifying the property eligible for additional first-year depreciation and how and from whom the property was acquired. Further, tax basis determined under Code Section 1016 is to be reduced by the amount of the Section 179 depreciation deduction.

For the small business, these additional depreciation computations add to the complexity of determining capital cost recovery. Any incentive to purchase new, depreciable machinery and equipment is probably motivated more by the investment tax credit provisions than the maximum $2,000 annual deduction available under Code Section 179. Particularly if other segments of the depreciation provisions under Code Section 167 were to be liberalized, Code Section 179 (and its attendant complexities) could be eliminated.

(8) Recapture of Depreciation—Code Sections 1245 and 1250. These sections provide for the recapture as ordinary income of all or a part of the depreciation claimed with respect to the assets sold when these assets are sold in excess of basis. The tax policy objective is to preclude the conversion of ordinary income into capital gain through the acceleration of ordinary deductions, with the subsequent disposition of the Section 1231 asset for a gain treated as a capital gain.

Various small business groups have suggested that the complexities of the recapture provision computations necessitate the elimination of the recapture requirements (at least with respect to small businesses). The computation will, of course, require a verification of historical cost and of the depreciation accumulated in every year since acquisition. Even the most rudimentary accounting systems, however, should enable this computation to be made. This may be a situation where

tax equity, that is, limiting the opportunity for conversion, should prevail over simplification, unless some simplified method can be implemented to limit annual tax depreciation to economic obsolescence.

TAX ADMINISTRATION

Tax Return Filing Considerations [30]

(1) Types of Return Filings.[31] The type of federal income return to be filed by the small business taxpayer is dependent upon that taxpayer's legal status:

(a) If in proprietorship form, the profit or loss from such activity is reported on Schedule C, which is to be attached to the proprietor's Form 1040.

(b) If in partnership form, the profit or loss from such activities is reported on the U.S. Partnership Return of Income, Form 1065. The partner's share of income, credits, deductions, and so forth is reported on Schedule K-1, which is part of the Form 1065. That information is then incorporated into Schedule E (Supplemental Income Schedule) and attached to the partner's Form 1040.

(c) If in corporate form, the profit or loss is reported on the U.S. Corporation Income Tax Return, Form 1120. Dividends to the shareholders are to be reported on Schedule B and incorporated into the shareholder's Form 1040.

(d) If in corporate form and a "Subchapter S election" is in effect, the corporation's profit or loss is reported on the U.S. Small Business Corporation Income Tax Return, Form 1120 S. The shareholder's portion of that information is then incorporated into Schedule E (Supplemental Income Schedule), which is part of the shareholder's Form 1040.

(2) Comparison of the Income Tax Returns. A small business taxpayer's exposure to the federal income tax normally occurs through a

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[30] In Senator Gaylord Nelson's October 26, 1977, Memorandum on Tax Reform Proposals to President Carter, Senator Nelson observed that "[a]bout 40 per cent of small business paperwork is tax forms" and that "simplification of tax forms is an essential part of tax reform for small business."

[31] The starting point for the preparation of a small business federal income tax return (whether the Schedule C or Forms 1065, 1020, or 1120 S) is the TAX GUIDE FOR SMALL BUSINESS (IRS Publication 334), annually revised. This complements YOUR FEDERAL INCOME TAX (IRS Publication 17). For more specialized business pursuits, the Internal Revenue Service provides the FARMER'S TAX GUIDE (IRS Publication 225) and the TAX GUIDE FOR COMMERCIAL FISHERMAN (IRS Publication 595).

tax return filing requirement, not a reading of the substance of the Internal Revenue Code. The tax form functions as the roadmap that enables him to compute his tax liability. The question then becomes whether these roadmaps are sufficiently clear to enable completion of the form without undue chances of error or frustration.

The Schedule C is the only one of the small business income tax reports that does not require a balance sheet. This appears to be the major difference between these forms. The partnership form and the Subchapter S form must of necessity also include forms summarizing the profit allocations to the owners. This provides for additional administrative complexity. The partnership return itself is applicable to both the two-man law firm or medical practice and the large syndicated limited partnership in which numerous partnership interests have previously been sold through a prospectus soliciting the wide distribution of such interests.

Questions to be raised in this context include: Whatever the form of organization, should different types of forms be required based on the size of the business? Should a variety of forms be structured to accommodate various types of business? [32] Should different types of partnership returns be constructed based on the number of partners, the size of the business, or the type of income?

The Small Business Administration, proceeding from a different perspective, has proposed a return that would be applicable to all types of small business. To implement its proposal, the SBA has prepared a draft "Small Business Enterprise Return" to apply to small businesses, regardless of their form of organization under local law. This return seems to include the same degree of complexity that is already included in the partnership or Subchapter S returns. For example, it includes a balance sheet and information about the income to the equity owners.

(3) Working from a Simplified Small Business Tax Return to the Tax Code Provisions. In confronting the problem of individual taxpayer complexity, the United States Treasury Department, in its April 30, 1973, *Proposals for Tax Change* suggested a unique approach: working from the tax return to the Internal Revenue Code, rather than from the Internal Revenue Code to the construction of an appropriate tax return. The concept was to identify the "average taxpayer." For example, were the sources of his income wages, interest, dividends, capital gains, and so forth? The focus was to identify the problems en-

[32] The IRS STATISTICS OF INCOME present categories that might be appropriate for this purpose.

countered by the taxpayer in reflecting these most common items on his tax reporting form and, then, to prepare a form to significantly reduce those problems. In essence, the "prime objective was to achieve a simple format and to reduce record-keeping." [33]

Perhaps a similar approach might be used in the small business tax reporting context. This would necessitate some quantification of the most common reporting problems encountered by the small business. This might start from the assumption that for many small businesses the tax information is the only accounting information that is developed.

One of the most important assumptions to be made in proceeding to draft the "perfect return" is to determine whether simplicity is best effectuated by (a) the cash method of receipts and disbursements or (b) an accrual method that conforms to generally accepted accounting principles for reporting to shareholders, other owners, and creditors. If small businesses are not concerned about preparing statements of financial results (except perhaps to bankers to facilitate loans), the cash method might be the best method upon which to proceed.

Recordkeeping and Document Retention Requirements

(1) Recordkeeping. The matter of small business recordkeeping is one of the major problems confronting small business tax administration. The first few pages of the *Tax Guide for Small Business* are devoted to defining "books and records," describing a single entry and a double entry bookkeeping system, and enumerating the requirements concerning accounting periods and accounting methods. The IRS packet of tax materials for new businesses notes the importance of adequate recordkeeping. The Service has issued Publication 583,[34] which provides 14 pages of recordkeeping instructions. The agenda and discussion papers for meetings of the Internal Revenue Service's Advisory Committee on Small Business indicate that recordkeeping and documentation constitute the largest audit problem for the Service.

The Service obviously cannot assist all small business taxpayers in implementing their own recordkeeping systems. In regard to tax returns, however, the Service might examine how the tax return can be structured so that information sought to be elicited can best be provided and how an adequate documentation system can be developed to assure accuracy of that information.

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33 DEPARTMENT OF THE TREASURY, PROPOSALS FOR TAX CHANGE 26 (1973).

34 RECORDKEEPING FOR A SMALL BUSINESS (IRS Publication 583).

(2) **Document Retention.** Internal Revenue Service Publication 583 states that the small business taxpayer is "required to keep the books and records of your business available at all times for inspection by Internal Revenue officers. Your records must be retained as long as their contents may become material in the administration of any Internal Revenue law." [35] In addition, records that support an item of income or deduction appearing on a return should be retained until expiration of the statute of limitations for that return. The publication further notes, however, that in many cases a taxpayer should retain his records indefinitely. This would occur, for example, where a method of accounting is changed and records supporting the necessary adjustments remain material for an indefinite period. This would also occur with respect to records relating to the basis of property still owned. In this context, the Service observed that "[o]ccasionally, Congress passes laws which provide relief for taxpayers if they can establish facts that can be proved only by records of transactions in prior years."

Assuming adequate records do exist at the time the tax return is filed, how long should these records be retained? Should more definitive guidelines be provided to the small business taxpayer than are provided in the *Tax Guide for Small Business*? Can the tax return itself be so structured to assist such retention either by the taxpayer himself or by the Service's computer network? This latter idea would seem particularly appropriate in the context of establishing tax basis.[36]

Tax Elections—Should They Be Eliminated or Reduced in Number?

Many of the proposals for small business tax simplification in the depreciation context have been concerned with implementing restrictions on the flexibility available in determining depreciation deductions, including, for example, the useful life or the appropriate method (straight line, declining balance, and so forth). Election opportunities are not limited, however, to depreciation computation matters.

The availability of tax elections appears to contribute substantially to the complexity of the tax structure. In addressing small business tax simplification, should the extensive availability of elections be re-

[35] *Id.* at 5.

[36] It will be observed that under the Tax Reform Act of 1976 the Congress enacted I.R.C. § 6039A, requiring that the deceased's personal representative furnish in writing to each person acquiring an item of carryover basis property from the decedent the adjusted basis of the property. I.R.C. § 6039A also requires the deceased's personal representative to furnish to the Secretary such § 1023 carryover basis information as the regulations may require.

duced? At what price can this be accomplished when considered in terms of tax equity, tax revenue, or tax expenditures?

Payroll Tax Returns

(1) Defining Employee Status for Payroll Purposes. The problem of determining employee status for payroll purposes is often troublesome to the small business. If a person is an independent contractor, no payroll withholding is required and no employer taxes are payable. If, however, the person is an employee, full compliance with withholding and tax payment requirements is triggered.

Controversies over independent contractor or employee status consume inordinate amounts of both the Service's and the small business taxpayer's time. The reclassification of a person claiming independent contractor status as an employee can result in the assessment to the small business of social security taxes (both the employer and the employee portions), unemployment taxes, interest, and penalties.

Code Section 3401(c) specifies only that the term *employee* includes governmental employees and officers of corporations. No further enlightment is provided in the Code. Two alternative (or complementary) proposals might be made that would simplify the definition of the term *employee:*

(a) Minimum wage payment. If a person rendering services were paid less than a specified amount (such as $250) in a calendar quarter, he would not be classified as an "employee" for payroll tax purposes.

(b) Industry classifications. More definite standards (perhaps on an industry-by-industry basis) for the determination of employee status might be established.

(2) Frequency of Payroll Tax Returns. Payroll taxes of $200 or more, but less than $2,000 a month, must be deposited within 15 days after the end of the month. Payroll taxes of $2,000 or more within any quarter-monthly period must be deposited within three banking days after the end of the quarter-monthly period. These taxes are reported on Form 941.[37]

The inquiry from the perspective of the small business is whether the limits for monthly or quarter-monthly deposits should be increased.

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[37] In Senator Gaylord Nelson's October 26, 1977, Memorandum on Tax Reform Proposals to President Carter, Senator Nelson, noting that Congress had voted that the Form 941 be consolidated into an annual form, observed that [t]his will eliminate a stack of reports almost two miles high each year."

Requiring less frequent deposits will ease the paperwork burden on the small business, with its limited and often unskilled clerical staff. The countervailing consideration, however, is whether the risk of loss to Internal Revenue will be inordinately increased by this delay.

State and Local Considerations

The federal tax is often only one of several income taxes with which the small businessman must be concerned. State and local taxes, with their additional reporting requirements, may impose substantial burdens. The small business that extends into several states will need to consider the impact of the state and local taxes of several jurisdictions. Each of these tax systems will often have its own set of substantive rules and reporting requirements.

The Federal-State Tax Collection Act of 1972, enacted as Title II of the revenue-sharing bill (Public Law Number 92-512), authorized the Internal Revenue Service to administer a combined federal-state individual income tax if the state so chose (that is, a "piggyback" system). The idea was that the taxpayer could file a single annual return for both purposes.[38]

In his November 7, 1977, speech before the National Tax Association—Tax Institute of America meeting, Commissioner Jerome Kurtz indicated that states have not been prone to elect this option.[39] Other papers published as a result of these proceedings suggest a similar result. One of the apparent concerns is the loss by the state taxing authorities of their autonomy. If a state elects piggybacking, it must accept the federal income tax law by enacting either a qualified tax that is a flat percentage of total federal tax or is a state tax at a flat rate or a progressive tax rate on federal taxable income. Proposed regulations on federal-state collection procedures have been issued.[40] Commissioner Kurtz further indicated in his speech that a "plain language" booklet on the piggybacking program is being prepared for publication.

Several suggestions might be made to alleviate some of these difficulties.

[38] In the St. Louis study (p. 13) the Task Force, after recognizing the federal reporting changes expressed by Public Law 94-202 (to be effective in January, 1978), recommended that the Federal Payroll Tax Form 941 be altered so that these federal forms can also be used in reporting wage withholding information to local jurisdictions. Specific recommendations included adding sections for reporting state income tax withholding, city income tax withholding, state employment security contributions, and unemployment taxes.

[39] *See* Daily Tax Report at G-5 (Nov. 7, 1977).

[40] *See* Daily Tax Report at J-1 (Sept. 29, 1977).

(1) Improve the Internal Revenue Service's capacity to function as the reporting and collecting instrumentality for the state and local taxing units (that is, the "piggybacking" system).

(2) Encourage the formulation of uniform state and local taxation statutes (similar to the concept of the Uniform Commercial Code and other uniform laws) for imposition of the more frequently imposed state and local taxes.

(3) Encourage a uniform reporting to enable the adoption of a multi-state reporting form.

THE SMALL BUSINESS OWNER AND FEDERAL ESTATE TAX COMPLEXITY

Scope of the Federal Estate Tax [41]

The federal estate tax is a tax imposed upon the estate of a deceased individual for the privilege of transferring value to successors. The purpose of this segment of this discussion is to identify estate tax complexity considerations as they relate to testamentary transfers of small business ownership.

The federal estate tax structure now incorporates various provisions relevant to small business interests held by the decedent, including two separate extended payment provisions for estate taxes attributable to a closely held business (Code Sections 6166 and 6166A) and a valuation section (Code Section 2032A). Further, Code Section 303 provides certain relief from dividend treatment when closely held stock is redeemed so as to liquidate estate tax and similar liabilities.

In addition, of more general applicability, in the Tax Reform Act of 1976 the Congress provided for:

(1) A credit (in substitution for the prior $60,000 exclusion) that, after being fully phased in during 1981, will enable $175,625 to be transferred tax free

(2) A substantially liberalized marital deduction (by providing a minimum $250,000 deduction).

The Senate Select Small Business Committee has observed that these liberalizing provisions mean "that most farmers and small business-

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[41] Richard Covey estimates that "small business assets" constitute about 9 per cent of the total gross estate totals. *See* statement by Richard B. Covey, *Hearings of Senate Select Comm. on Small Business, Small Business Tax Reform*, 94th Cong., 1st Sess. 1357, 1375 (1975).

men should be able to transfer the major portion of their estate tax free to the next generation. This, in turn, means that these enterprises will not have to be sold in whole or in part to pay federal estate taxes, as is currently so often the case." [42]

Valuation

(1) Code Section 2031. Pursuant to Code Section 2031, the value to be included in the federal gross estate is the fair market value of the property interest at death (or at the alternate valuation date if elected by the executor or administrator). The "fair market value" is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts.

Valuation questions constitute the largest number of estate tax audit issues. In Revenue Ruling 59-60, 1959-1 C.B. 237, dealing with the valuation of closely held corporations, the Service indicated (in Section 3.01) that "[a] determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases." Accordingly, asuming no general statutory valuation formula can be constructed, these valuation controversies, including those concerning small business, will continue.

(2) Code Section 2032A—Valuation for Closely Held Farms and Businesses. The fair market value of the property interest at the date of decedent's death is normally determined by referring to the "highest and best use" to which the property can be put. In enacting the Tax Reform Act of 1976, the Congress concluded that this "highest and best use" standard should be made inapplicable to family farms and closely held businesses. The Congress noted that the substantial estate tax burden makes the continuation of the family farm or the closely held business activities unfeasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Accordingly, the Congress provided under Code Section 2032A that a "special use valuation" may be used in situations involving real property used in family farms or in certain other trades or businesses. Code Section 2032A also provides, however,

[42] Senate Select Comm. on Small Business, 27th Annual Report, S. Rep. No. 95-30, 94th Cong., 2d Sess. 45 (1977).

for the recapture of the estate tax benefit when the land is sold prematurely or is converted to nonqualifying uses.

Special percentage tests are prescribed to determine eligibility for this special use valuation. The following alternative valuation methods can be used.

(a) A "farm method" is prescribed for farms that qualify for special use valuation. This method involves a mathematical computation that has as its purpose the reduction of subjectivity and, thereby, controversy, in farm valuation. The cause of simplicity is thereby promoted.

(b) A "multiple factor method" is used in determining special use valuation for qualifying real property not used in farming and for qualifying farm real property if the special farm method is not used. This method would appear to have more subjectivity and, therefore, complexity than the "farm method."

Either of these methods, however, provides greater certainty than does the Section 2031 approach.

Extension of Time for Payment of Estate Taxes (Code Sections 6166 and 6166A)

Prior to the Tax Reform Act of 1976, an executor could elect to pay the estate tax in installments over 2 to 10 years where the estate consisted largely of interests in a closely held business or businesses. To qualify under this provision, the value of the interest in the closely held business must have exceeded 35 per cent of the value of the gross estate or 50 per cent of the taxable estate of the decedent. For this purpose, the term *interest in a closely held business* was an interest as the proprietor in a trade or business, an interest as a partner in a partnership having not more than 10 partners or in which the decedent owned 20 per cent or more of the capital, or an interest as an owner of stock in a corporation having not more than 10 shareholders or in which the decedent owned 20 per cent or more of the voting stock. If the decedent's gross estate included more than 50 per cent of the value of each of two or more closely held businesses, those businesses could be treated as a single closely held business in determining whether either the 35 per cent or the 50 per cent test was satisfied.

Code Section 6166 of the Tax Reform Act of 1976 now provides a 15-year period for the payment of the estate tax attributable to the decedent's interest in a farm or other closely held business. The executor may elect to defer the estate tax (but not the interest on the

tax) for a period of up to 5 years and, thereafter, pay the tax in equal annual installments over the next 10 years. To qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 65 per cent of the value of the gross estate, as reduced by expenses, indebtedness, and losses.

The definition of a closely held business has been changed to include situations in which the decedent had a 20 per cent capital interest in the partnership or the partnership has 15 or fewer partners (rather than 10 under the prior Code Section 6166) and situations in which the decedent had at least 20 per cent of the voting stock of the business or the corporation has 15 or fewer shareholders (rather than 10 under the prior Code Section 6166). Where two businesses are sought to be aggregated to determine deferral qualification, 20 per cent (rather than 50 per cent) of the total value of each business is to be included in the decedent's estate.

The Tax Reform Act of 1976 retained the current 10-year extension for payment of estate tax where the value of the closely held business exceeds 35 per cent of the value of the gross estate or 50 per cent of the taxable estate of the decedent. This provision was redesignated as Code Section 6166A.

After the Tax Reform Act of 1976, therefore, three different percentage-of-assets tests exist merely for determining whether a business is a small business that may qualify for deferral. Two different systems exist for determining whether several businesses can be amalgamated for qualification purposes. Two different systems exist for determining whether an interest is an interest in a "closely held business." This multiplicity of qualification tests does not appear to meet any reasonable standard of "simplicity."

Corporate Stock Redemptions for Estate Taxes—Code Section 303

Code Section 303 enables the estate (or other successor) of a deceased shareholder to receive capital gains treatment (rather than ordinary income or dividend characterization) on amounts received in redemption of the stock of a deceased shareholder that do not exceed the amount of the federal and state death taxes payable, plus administrative expenses. To be eligible under this section, the stock owned by the decedent must make up more than 50 per cent of his adjusted gross estate. If the decedent owned stock in two or more corporations, the stock may be treated as the stock of a single corporation for pur-

poses of Section 303, provided the decedent owned more than 75 per cent in value of the stock of both corporations. Revisions to Code Section 303 in the Tax Reform Act of 1976 were designed to make this special capital gains treatment available only if: (1) the closely held business interest constitutes a substantial part of the estate of the decedent and (2) the party whose shares are redeemed actually bears the burden of estate taxes, state death taxes, or funeral and administration expenses in an amount at least equal to the amount of the redemption.

Taxpayers' representatives are generally aware of the differences between the percentage tests for qualification under Code Sections 303, 6166, and 6166A. The cause of simplicity would be served, however, by standardizing all these percentage criteria.

Carryover Basis Complexity

The question of capital gains at death, carryover basis at death, or stepped-up basis at death permeates the entire economic fabric, including the small business sector. It will be recalled that:

(1) Prior to the Tax Reform Act of 1976, Code Section 1014 provided for the step-up in basis at death of appreciation unrealized as of death, except in regard to "income in respect of a decedent," as to which taxation is suspended under Code Section 691 until the cash is received.

(2) The Tax Reform Act of 1976 includes Code Section 1023, which provides for the carryover of basis at death of appreciated property transferred at death. Several significant favorable adjustments are permitted in the form of the "fresh start" rule and basis increases for estate and inheritance taxes attributable to the appreciation element inherent in the transferred property.

(3) In its September 2, 1977, *Option Paper No. III, Capital Gains and Losses,* the Treasury Department, although not recommending it, indicated that a proposal had been developed to provide that appreciation in property (occurring after 1976) transferred at death would generally be taxed at death. Long-term averaging would be provided under that proposal. No such tax, however, would be imposed upon transfers to a surviving spouse or upon transfers of closely held business interests and farms. In these latter situations, the cost or other basis of the property to the decedent would carry over to the heir.

The Treasury Department concluded that carryover basis would, in any event, be needed for transfers to a spouse and for transfers to family

members of a closely held business or a farm. The Treasury Department then observed that "the complexities of this rule cannot be avoided." Accordingly, the Treasury Department concluded that, at this time, no attempt should be made to tax gains on transfers at death or by gift.

Any future attempt to impose a capital gains tax at death that includes a "small business" exception will introduce additional complexity into the system. Definitions will need to be devised to determine whether a taxpayer's estate qualifies. As noted above, different small business qualification tests have already been fashioned for estate tax liquidity purposes (Code Sections 6166 and 6166A) and for death tax stock redemption purposes (Code Section 303). Whether any additional complexity is necessary is questionable.

THE PROCESS OF SMALL BUSINESS TAX SIMPLIFICATION

Forums Generating Small Business Taxpayer Proposals

A substantial concern of the small business taxpayer appears to be that the business-oriented tax laws are often enacted from the perspective of the medium and large business taxpayer.[13] A similar complaint is made that the small business viewpoint is ignored in the tax regulations and the interpretative and administrative process. Significant small business tax representation, however, does occur in many segments of the federal government.

The primary legislative committee representing the interests of the small businessman has been the Senate Select Committee on Small Business, under Chairman Gaylord Nelson (D. Wis.). Mr. Nelson is also a member of the Senate Finance Committee. This committee has a Tax Counsel (currently Herbert Spira). In the House of Representatives, the Small Business Committee normally deals with small business problems outside the orbit of the federal tax structure. Neither the House Ways and Means Committee nor the Senate Finance Committee has a standing subcommittee charged with dealing with small business taxpayer problems. Further, the staff of the Joint Committee on Taxation does not have a person who specializes in the tax problems of small business.

The United States Department of the Treasury does not have any

[13] *See Joint Hearings of the Senate Select Comm. on Small Business and the Senate Subcomm. on Financial Markets, Small Business Tax Reform,* 94th Cong., 1st Sess. 1166 (1975).

specifically designated group or individual to deal regularly with the problems of the small business.[44] The Department of the Treasury did have a Small Business Advisory Committee on Economic Policy. This group had task forces on tax policy, equity capital, long-term credit, and government paperwork and regulation. A report was prepared, *Treasury Small Business Advisory Committee on Economic Policy—Report of Recommendations to the Secretary of the U.S. Department of the Treasury* (December 1976).[45] New members of the Treasury Department Small Business Advisory Committee were appointed in late 1977.

During 1975 and 1976, the Internal Revenue Service also had an advisory committee with former IRS Commissioner Randolph Thrower as its chairman. The agenda for discussion at its various meetings has included the following topics:

(1) Small business adjustment to ERISA

(2) Possible staggered filing seasons

(3) Changes to estimated tax and tax deposit procedures

(4) IRS public information programs for small business.

The Small Business Administration also deals with the problems of small businesses, but primarily from the perspective of financing these businesses, rather than taxing them.[46]

Political Appeal

The tax simplification problems of the small business appear to have significant political appeal. This is evidenced by the history of small

[44] In S. 1089, the 1973 version of the Small Business Tax Simplification Reform Act, an office of Small Business Tax Analysis would have been created in the U.S. Department of the Treasury (*see* Asbill testimony, *Hearings, supra* note 41, at 1445, 1450).

[45] This report is reproduced as Appendix N in the SENATE SELECT COMM. ON SMALL BUSINESS, 27th ANNUAL REPORT, S. Rep. No. 30, 95th Cong., 1st Sess. 50 (1977).

[46] As noted with respect to various topics discussed above, on June 3, 1977, the SBA issued a report, required pursuant to Pub. L. No. 94-305, containing recommendations relating to simplification of the tax laws for small business. The study recommends for small business: (1) a simplified LIFO inventory method, (2) a depreciation allowance for twice the amount allowable under the straight-line method but with the repeal of the first-year bonus depreciation provision, and (3) an exemption from the depreciation recapture provisions. Further, the study suggests that a "bias" against small business is created by the complexity of the tax system. The study recommends that Congress should: (1) initiate a comprehensive study of the problems created by the multiplicity of taxes at various governmental levels, (2) set guidelines to determine employee status for payroll tax purposes, (3) provide a quick refund for overpayments of estimated taxes, (4) establish a program of tax education for operators of small businesses, and (5) allow court costs and attorney fees for successfully challenging the government in a tax dispute.

business tax legislation (see Appendix One of this paper), as well as the continuing development of small business tax studies and recommendations, including:

(1) The Small Business Administration's June 3, 1977, three-part study, presented in accordance with the Congressional mandate in Public Law Number 94-305

(2) The references to the special problems of small business in the Joint Committee on Taxation's report, *Issues in Simplification of the Income Tax Laws* 55 (September 19, 1977)

(3) The Treasury Department's recommendations for specific tax reductions for small business, as included in the 1977 *Tax Reform Option Paper No. IX.*

In addition, it will be recalled that during the reorganization of the Senate when the 95th Congress convened in January 1977, the efforts to eliminate the Select Committee on Small Business were unsuccessful. From this background of small business tax treatment and the current interest in this topic, it would seem that small business simplification would have very significant political appeal as part of an overall simplification package.[47]

[47] The Treasury Department's attitude may be that small business simplification would have too much Congressional appeal since, in the Option Paper, the Treasury noted (with respect to the corporate tax rate reduction proposal) that "[i]t is probable that the small business advocates in Congress can obtain support to make the entire rate reduction applicable to small business." DAILY EXECUTIVE REPORT No. 196 at 53 (Special Supplement). After President Carter's 1978 tax reduction and tax revision proposals, Senator Nelson promptly responded by scheduling hearings of his Select Committee on Small Business to analyze the effects of the proposal on small business.

Appendix One

History of Proposed Tax Legislation Dealing Specifically with Small Business and Its Tax Problems*

Prior to the early 1950's, there was little tax legislation specifically designed to benefit small business. There had been no concerted and systematic effort to isolate the tax problems of small business, to analyze the impact of the tax structure on these problems, or to recommend legislative relief. In 1952, however, nationwide investigations of small business tax problems were initiated.[1] Congress responded with various provisions in the Internal Revenue Code of 1954.[2]

THE SMALL BUSINESS TAX LEGISLATION OF 1958

In 1957, the Senate Select Committee on Small Business instituted another major, nationwide investigation of small business tax problems. In its 1977 study, the SBA concluded that the three volumes of testimony from these hearings, conducted in 14 cities throughout the United States, "dramatically revealed the biases and inequities of the existing tax system against small business." [3] At the conclusion of the investigation in 1958, the Committee's report [4] was submitted to the Senate, and a seven-point small business tax adjustment bill was introduced. The Technical Amendments Act,[5] passed in the summer of 1958, contained four of the seven proposals from the tax adjustment bill:

* This is adapted from the discussion in SMALL BUSINESS ADMINISTRATION, *The Tax Law and Small Business,* in THE STUDY OF SMALL BUSINESS, PART III, THE IMPACT OF TAXATION ON SMALL BUSINESS: A PROPOSAL FOR REFORM, (1977).

1 *Tax Problems of Small Business, Hearings Before the Select Committee on Small Business,* in Bridgeport, Conn. (March 13, 1952); Newark, N.J. (March 14, 1952); Los Angeles, Calif. (March 28, 1952); Minneapolis, Minn. (April 24, 1952); Birmingham, Ala. (April 10, 1952); Chicago, Ill. (May 15, 1952); and Cleveland, Ohio (May 15, 1952); 82d Cong., 2d Sess. (1952). TAX PROBLEMS OF SMALL BUSINESS, S. REP. No. 442 (1953).

2 Pub. L. No. 591, 83d Cong., 2d Sess. (1954).

3 *Tax Problems of Small Business: The Impact of Federal Taxation on Small Business," Hearings Before the Select Committee on Small Business,* in Phoenix, Ariz. (Sept. 16, 1957); Los Angeles, Calif. (Sept. 18, 1957); San Francisco, Calif. (Sept. 20, 1957); Boston, Mass. (Sept. 30, 1957); New York, N.Y. (Oct. 2, 1957); Minneapolis, Minn. (Nov. 3, 1957); Portland, Ore. (Nov. 15, 1957); Denver, Colo. (Nov. 20, 1957); Wichita, Kan. (Nov. 22, 1957); Birmingham, Ala. (Dec. 2, 1957); Dallas, Tex. (Dec. 4, 1957); and Milwaukee, Wis. (Dec. 10, 1957); 85th Cong., 1st Sess. (1957).

4 S. REP. No. 1237, TAX PROBLEMS OF SMALL BUSINESS (1958).

5 Pub. L. No. 85-866, 85th Cong., 2d Sess. (1958).

(1) A tax option permitting owners of closely held corporations to be taxed in some respects as partners in a partnership (Subchapter S) [6]

(2) An allowance of additional depreciation for 20 per cent of the cost (with certain limitations) of new or used personal property [7] recognizing the frequent purchases of used assets by small businesses

(3) An option to defer payment of estate taxes for up to 10 years for the estates of deceased owners of small businesses [8]

(4) An increase in the accumulated earnings credit from $60,000 to $100,000.[9]

In 1958, the Small Business Investment Act [10] was also enacted, creating the Small Business Investment Company (SBIC) as a vehicle for providing financing to small business. Pursuant to the SBIC legislation, provisions were enacted granting tax benefits to these companies and their shareholders.[11] All of the 1958 small business tax provisions still remain in the Internal Revenue Code, although some have been modified in the interim.

THE BIBLE-EVINS BILL

During the period from 1958 until 1967, although there was considerable tax legislation, little attention was given to further small business tax relief.[12] Early in 1967, the Senate Select Committee on Small Business began a continuing study of the tax system from the viewpoint of small business. This research resulted in a series of legislative proposals, culminating in a broad small business tax bill introduced as the Small Business Tax Simplification and Reform Act of 1970.[13] This bill, after consultation with the Commerce Department, Small Business Administration, Treasury Department, representatives of small business organizations, and government and private specialists,

[6] I.R.C. §§ 1371-1379, *added by* § 64(a) of Pub. L. No. 85-866.

[7] *Id.* § 179, *added by* § 204(a) of Pub. L. No. 85-866.

[8] *Id.* § 6166A, *added by* (as § 6166) 206(a) of Pub. L. No. 85-866.

[9] *Id.* § 535(c), *amended by* § 205(a) of Pub. L. No. 85-866.

[10] 15 U.S.C. §§ 661-696.

[11] I.R.C. §§ 172(a), 172(b)(1)(F), relating to carryover and carryback of net operating losses; *id.* § 243, relating to the corporate dividends received deductions; *id.* §§ 542(a), 542(c)(8), relating to the definition of a personal holding company; *id.* § 582(c)(1), relating to bad debts, losses, and gains with respect to securities held by financial insitutions; *id.* § 586, relating to reserves for losses on loans of SBIC's; *id.* § 1242, relating to losses on SBIC stock; and *id.* § 1243, relating to losses sustained by SBIC's.

[12] Although little legislation specifically concerning small business was introduced, hearings were conducted by the small business committees to determine the impact of pending legislation on small business.

[13] S. 4039, introduced on June 30, 1970.

was reintroduced the following year as the Small Business Tax Simplification and Reform Act of 1971.[14] After further modification, the bill was reintroduced a second time as the Small Business Tax Simplification and Reform Act of 1973 (commonly called the Bible-Evins Bill).[15] The Bible-Evins Bill, in its various forms, was the first comprehensive small business tax legislation to come before Congress since 1958 and only the second comprehensive small business tax reform proposal ever to come before Congress. The Bible-Evins Bill, in its 1973 version, was divided into eight parts, each dealing with a specific stage of business growth or specific form of business organization. It included the following provisions.

Tax Simplification

For continuing analysis of the tax law and its impact on small business, the bill proposed a standing intragovernmental committee on tax simplification for small business [16] and a permanent office of small business tax analysis in the Treasury Department.[17] To facilitate understanding of small business tax provisions, the bill suggested arranging all small and new business provisions in one section or chapter of the Internal Revenue Code.[18] Substantive simplification was suggested for depreciation policy [19] and employee fringe benefits.[20] Other provisions for simplification included less frequent collection of federal taxes,[21] the study of the differential effect of tax law changes on businesses of varying sizes and ages,[22] and the reimbursement of travel expenses for persons consulting with the Treasury Department on tax simplification and reform.[23]

Increase in Corporation Tax

To balance the revenue effect of the overall bill, the normal tax for corporations would have been increased slightly.[24]

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14 S. 1615 and H.R. 7692, introduced on April 22, 1971.
15 H.R. 5222, and S. 1098, introduced on March 6, 1972.
16 S. 1098 and H.R. 5222, § 101.
17 *Id.* § 102.
18 *Id.* § 103.
19 *Id.* § 104.
20 *Id.* § 105.
21 *Id.* § 107.
22 *Id.* § 106.
23 *Id.* § 108.
24 *Id.* § 201.

Provisions To Encourage Establishment of New Small Business Enterprises

Special provisions to encourage new small business enterprises included a three-year tax exemption for the first $25,000 of operating income,[25] liberalized rules for amortization of partnership organization expenses[26] and bad debt deductions,[27] an increase in the deduction for losses on small business stock,[28] and provisions to encourage new cooperatives.[29]

Provisions To Assist Small Business Growth

Incentives to assist small business growth included an increase in the first-year depreciation allowance,[30] the elimination of the reserve ratio test for small businesses electing Asset Depreciation Range guidelines for depreciation,[31] an increase in the net operating loss carryforward period,[32] an increase in the accumulated earnings tax credit,[33] the liberalization of the rules for amortization of research expenditures[34] and expenditures incident to the issuance of stock,[35] and the allowance of multiple corporate surtax exemptions for certain controlled family corporations.[36]

Partnership and Subchapter S Provisions

Partnership tax amendments would have modified the tax rules for guaranteed payments to estates of deceased partners,[37] for closing the taxable year of a deceased partner,[38] for terminating the partnership,[39] and for utilization by a partner of partnership losses.[40] Subchapter S changes would have increased and broadened the number of classes

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[25] *Id.* § 301.
[26] *Id.* § 302.
[27] *Id.* § 303.
[28] *Id.* § 304.
[29] *Id.* § 305.
[30] *Id.* § 401.
[31] *Id.* § 402.
[32] *Id.* § 403.
[33] *Id.* § 404.
[34] *Id.* § 406.
[35] *Id.* § 405.
[36] *Id.* § 407.
[37] *Id.* § 501.
[38] *Id.* § 502.
[39] *Id.* § 503.
[40] *Id.* § 504.

of shareholders,[41] eased rules relating to termination of the election,[42] and conformed the loss utilization rules for Subchapter S shareholders to those for partners.[43]

Tax Liability Payments

These provisions would have allowed refunds of overpayments of estimated taxes before the end of the taxable year[44] and disallowed interest deductions in excess of $500,000 for debt-financed acquisitions.[45] Estate tax changes would have simplified valuation rules for unlisted securities,[46] extended the time for payment of estate taxes,[47] and instituted a Treasury Department study of obstacles to the preservation of small business.[48]

Small Business Development Corporations

The bill contained two provisions to encourage state and local development companies.[49]

The Bible-Evins Bill was the most comprehensive tax reform proposal for small business ever to be presented to the Congress. Although it was not enacted in its entirety, its influence is evidenced by the fact that many of its provisions were subsequently enacted in the same or in modified form.[50] Some of its provisions served as a basis for the recommendations in the SBA report.

TAXATION AND SMALL BUSINESS SINCE 1973

Little comprehensive small business tax reform legislation has been proposed since 1973. In 1975, hearings were held before the Senate Select

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41 *Id.* §§ 601, 602.

42 *Id.* §§ 603, 604, 605.

43 *Id.* § 606.

44 *Id.* § 801.

45 *Id.* § 802.

46 *Id.* § 803.

47 *Id.* §§ 804, 805.

48 *Id.* § 806.

49 *Id.* §§ 701, 702.

50 *E.g.,* the Pension Reform Act of 1974 (ERISA) took steps to equalize fringe benefits; the Tax Reform Act of 1976 provided for amortization of partnership organization expenses, increased the net operating loss carryforward period, increased the number and broadened the classes of permissible shareholders for election under Subchapter S, simplified the estate tax valuation procedure for small business real estate, and liberalized rules for payment of estate tax; the Tax Reduction Act of 1975 increased the accumulated earnings credit and the corporate surtax exemption (this had an effect opposite to that

Committee on Small Business on the tax needs of small business pursuant to the enactment of the Tax Reduction Act of 1975.[51] These hearings investigated the impact of inflation and recession on small business. Other small business impact hearings have been held on pending tax legislation by the small business committees. Various members of Congress have introduced limited small business tax reform proposals.[52] Some of these have contained suggestions similar to those of the Bible-Evins Bill.[53] The Tax Reform Act of 1976 was of some help to small businesses, but the thrust of that legislation was to curtail tax shelter investments, to provide individual tax relief and simplification, and to reform the estate and gift taxes. The Tax Reduction and Simplification Act of 1977 contained some provisions helpful to all business, including small business.

The SBA's report concluded that "it is now appropriate for another comprehensive small business tax reform proposal to be formulated and presented to Congress to encourage the establishment and continued vitality of this vital segment of the economy." President Carter's subsequently announced 1978 tax revision proposals include the following:

(1) Reduction of the corporate tax rate, including the rate on the first $50,000 of taxable income

(2) A simple table of useful lives of equipment to be used by small business

(3) An increase in the allowable number of shareholders of a Subchapter S corporation and various other technical changes

(4) Broadening the favorable treatment under Code Section 1244 of losses on stock in a small business corporation.

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recommended in the Bible-Evins Bill, by reducing corporate taxes). In addition, intragovernmental small business tax advisory committees were established by the Internal Revenue Service and Treasury Department.

[51] *Small Business Tax Needs, Hearings Before the Select Committee on Small Business*, 94th Cong., 1st Sess. (1975).

[52] *E.g.*, H.R. 14837, introduced on May 16, 1974.

[53] H.R. 14837, like the Bible-Evins Bill, recommended increases in the first-year depreciation allowance and the extension of the net operating loss carryforward period.

Appendix Two

Bibliography of Small Business Tax Simplification Materials

Annual Reports of the Select Comm. on Small Business, U.S. Senate, including, particularly, *26th Annual Report,* S. Rep. No. 94-636, 94th Cong., 2d Sess. ch. IV, at 73; *27th Annual Report,* S. Rep. No. 95-30, 95th Cong., 1st Sess. ch. IV, at 39.

Committee on Tax Policy, New York State Bar Association, "A Report on Complexity and the Income Tax." 27 *Tax L. Rev.* 325 (1972).

Impact on Small Business of Recession and Inflation and Consequent Tax Proposals for Consideration as Part of Emergency Tax Reduction Legislation: Hearings Before the Select Comm. on Small Business, U.S. Senate, 94th Cong., 1st Sess. (1975).

Joint Committee on Taxation, *Staff Report, Issues in Simplification of the Income Tax Laws* 55-56, 101 (issued pursuant to the mandate in Section 507 of the Tax Reform Act of 1976).

Memorandum on Tax Reform Proposals by Senate Small Business Committee, presented to President Carter by Committee Chairman Gaylord Nelson (D., Wis.) at a White House Meeting, October 26, 1977 (as reproduced in BNA, *Daily Executive Report,* Oct. 28, 1977, at J-1).

Study of the Business Tax Structure as It Affects Small Business: Joint Hearing Before the Senate Select Committee on Small Business and the Subcommittee on Financial Markets of the Committee on Finance, 94th Cong., 1st Sess. (Sept. 23, 24, 25 and November 13, 1975).

U.S. Small Business Administration, Three-Part Study (prepared pursuant to Pub. L. No. 94-305), June 3, 1977, particularly Part III, "The Impact of Taxation on Small Business: A Proposal for Reform."

U.S. Small Business Administration, *The Report of the St. Louis Task Force on the Taxation of Small Business,* June 1977.

U.S. Treasury Department, Small Business Advisory Committee on Economic Policy, *Report of Recommendations to the Secretary, December, 1976,* as reproduced in Senate Select Committee on Small Business, *27th Annual Report,* S. Rep. No. 95-30, 94th Cong., 2d Sess., App. N, at 201.

Appendix Three

U.S. Government Organizations Interested in Small Business Tax Simplification*

ERISA Advisory Council (Small Plans Impact Work Group)

U.S. House of Representatives, Small Business Committee

U.S. Senate, Select Committee on Small Business

U.S. Small Business Administration (its office of Advocacy issued a three-part study dated June 3, 1977, including Part III, *The Impact of Taxation on Small Business: A Proposal for Reform*)

U.S. Treasury Department, Small Business Advisory Committee

Appendix 4 to Professor Streng's paper consisted of filled-in forms prepared by the Internal Revenue Service.

Appendix 5 to Professor Streng's paper consisted of Form 1120 SBE, reproduced from U.S. Small Business Administration, Part III, "The Impact of Taxation on Small Business: A Proposal for Reform," *The Study of Small Business*, App. A (1977).

Since these materials can be obtained from their original sources, they have not been reproduced here.

* Various private sector groups have been organized to support the interests of small business. The largest of these groups appear to be (1) The National Federation of Independent Businesses and (2) The National Small Business Association. A list of 26 small and independent business associations supporting the Senate Select Small Business Committee tax proposals is included as Attachment II to Senator Nelson's October 26, 1977, *Memorandum* presented to President Carter.

M

Simplification for Business Taxpayers' Inventories

J. Fred Kubik

Inventory management is a major concern in the question of a business; and its importance in accounting determinations of income and financial position for companies engaged in manufacturing, wholesaling, retailing, and some other industries cannot be overemphasized. One of the first lessons learned by small businessmen is that a variation in inventory pricing has a one-for-one impact on net taxable income.

Treasury Regulations provide that inventories are necessary in the calculation of net income in every case in which the production, purchase, or sale of merchandise is an income-producing factor.[1] According to IRS statistics,[2] approximately 7,700,000 nonfarm business income tax returns were filed for sole proprietorships for 1974. Of these, 1,650,000 reported end-of-year inventories. Of the 950,000 nonfarm partnership returns filed, 220,000 indicated end-of-year inventories. The total dollar amount of inventories reported by these nonfarm proprietorship and partnership businesses was 21.7 billion. In the corporate sector, inventories in 1972 totaled approximately $224 billion on a total of 1,800,000 corporate returns.[3] Statistics on how many of these returns included inventories were not provided. Over half of the total inventories, however, $125 billion, were reported on the 3,300 returns of corporations with over $50 million in gross receipts. Another $27 billion in inventories were reported on some 13,500 returns for corporations with gross receipts of between $10,000,000 and $50,000,000. Based on these statistics, it appears that over 60 per cent of the inventory dollar volume is reported on returns that constitute less than 1 per cent of the reporting units. Well over 90 per cent of the reporting units that

* J. Fred Kubik is a certified public accountant with F.B. Kubik & Co., in Wichita, Kansas.

1 Treas. Reg. § 1.471-1.

2 IRS, STATISTICS OF INCOME-1974, BUSINESS INCOME TAX RETURNS (IRS Publication 438).

3 IRS, STATISTICS OF INCOME-1972, CORPORATION INCOME TAX RETURNS (IRS Publication 16).

must deal with the problems of inventory costing would fall within most definitions of small business.

As will be discussed herein, the matter of dealing with inventory valuations is a complex subject for both accounting and tax purposes. It is reasonable to expect that a substantial percentage of the two-and-one-half million small businesses reporting inventories are experiencing difficulties in properly dealing with these complexities. Traditionally, the small businessman has simplified the problem by his own methods; and the Internal Revenue Service has not objected to this procedure.

BACKGROUND OF THE INVENTORY PROBLEM

Accounting Concepts

The general rule for inventories is provided by I.R.C. Section 471 as follows:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The rule first appeared in the Revenue Act of 1918, and thus generally tied the matter of inventory valuation to accounting practices.

The authoritative statement for the broad, general accounting principles concerning inventory pricing is Chapter 4 of *Accounting Research Bulletin No. 43*. Briefly stated, these principles are that the term *inventory* means those items of tangible personal property that are (1) held for sale in the ordinary course of business, (2) in the process of production for such sale, or (3) to be currently consumed in the production of goods or services to be available for sale. A major objective of accounting for inventories is to obtain a proper matching of revenues and costs. The primary basis for accounting for inventories is cost, which basically means the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Cost may be determined under any one of several assumptions concerning the flow of cost factors (such as first-in first-out (FIFO), average, and last-in first-out (LIFO)), depending on the method that most clearly reflects periodic income. A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its costs. This is generally accom-

plished by stating these goods at a lower level commonly designated as market. In determining the lower of cost or market, the term *market* means current replacement costs, except that:

(1) Market should not exceed the net realizable value (that is, estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Depending on the character and composition of the inventory, the rule of cost or market, whichever is lower, may properly be applied either directly to each item or to the total of the inventory or some of its components. The basis of stating inventories must be consistently applied.

Within these broad general principles, a great deal of flexibility is possible. Special industry practices have evolved; and even within an industry, it has been alleged that the variety of inventory pricing methods in use is such that companies in the same industry but using different inventory pricing methods can arrive at financial statements that cannot be compared meaningfully with one another.[4] In forming professional judgments on the compliance of inventory pricing with generally accepted accounting principles, independent auditors rely heavily on practicality, reasonableness, consistency, and materiality. It is suggested that examining revenue agents have frequently adopted this same mental attitude, which is in accord with the best accounting practice. The Treasury Regulations state:

> [T]hat inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with Sections 1.471-1 through 1.471-11.[5]

In 1973, the American Institute of Certified Public Accountants (AICPA) published a study undertaken to examine alternative methods available for pricing inventories and to make recommendations to assist policymakers in their efforts to narrow the range of acceptable practice. The author of this study stated that his inquiry showed ample evidence

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[4] H. BARDEN, THE ACCOUNTING BASIS OF INVENTORIES (1973).
[5] Treas. Reg. § 1.471-2(b).

concerning the existence of diverse inventory practices concerning both cost and cost flow assumptions, even for companies in the same industry and with similar types of products.[6] The author classified the diversity that he found in inventory practice in the following three general groups.

(1) Differences in the composition of product costs and in the allocation of cost to units of production. The questions revolve around determination of the costs to be associated with production operations and used in calculating unit product costs.

(2) Differences in cost flow assumptions used in compiling the cost of year-end inventories and cost of products sold. Problems generate from the potential lack of valid comparability between LIFO applications and between LIFO and FIFO applications in substantially similar circumstances.

(3) Differences in implementation of the concept of lower of cost or market. Differing interpretations of the meaning of the term *market* and complexities in applying the present rule can result in significant differences in reported results.

It should be noted that the author, in making this study, was consulting with corporate financial executives, their independent accountants, and the top technical partners of 11 large accounting firms. He was finding a diversity of practice within a very knowledgeable group. Clearly, the matter of inventory costing is not an exact science, and there is no *one* "best accounting practice in the trade or business." [7]

Internal Revenue Service Enforcement Activities

The current special interest of the Internal Revenue Service in the inventory valuation problem seems to date from President Kennedy's tax message to Congress on April 20, 1961, in which he stated that he was directing the Internal Revenue Service to give increasing attention both to the verification of the amounts reported as inventories and to an examination of the methods used in arriving at their reported valuations. One commentator has speculated that this statement by the President may have resulted from a letter issued by a prominent Washington tax attorney proclaiming that if the federal government wanted to pay off the national debt and balance the budget, all it needed to

[6] H. Barden, *supra* note 4, at 10.

[7] Division of Federal Taxation of the American Institute of Certified Public Accountants, Comments on the Proposed Regulation Under Section 471 of the Internal Revenue Code Relating to the Use of the Full Absorption Method of Inventory Costing (1973) [hereinafter cited as AICPA Comments].

do was audit inventories for federal income tax purposes.[8] Tax practitioners working in the small business area shuddered at the thought of the avalanche of tax controversies that would result if the Internal Revenue Service really carried out the President's directive.

Prior to 1961, the matter of inventory verification in Internal Revenue Service examinations had been concerned with consistency. The courts had compelled the commissioner, when correcting a continuing understatement resulting from an erroneous inventory practice, to adjust the opening and closing inventories in all open years. The understatement of inventory as of the end of a year closed to assessment could not be reached. In order to avoid this result, agents ignored the inventory error.[9]

Code Section 481 was a partial remedy for this problem, since it required an adjustment to prevent the omission or duplication of income caused by accounting method changes. But if the change was not initiated by the taxpayer, the application of Section 481 is limited to that portion of the net adjustment that is not attributable to years prior to 1954. Thus agents still left inventory undisturbed. After President Kennedy's directive, the argument of "error correction," rather than a "change in accounting method," became a popular tool of examining agents in attempting to avoid the provisions of Section 481.[10] Then, in 1964, Revenue Procedure 64-16,[11] (now Revenue Procedure 70-27) was issued. Under this procedure, the question of whether or not the changed accounting practice constituted a change of "method of accounting" was not to be raised, considered, or conceded by either the taxpayer or the Internal Revenue Service. The procedure provided for a ratable 10-year spread forward of the adjustment necessary because of the change, and it required the taxpayer to forego the exclusion from income of the adjustment attributable to pre-1954 years. The procedure was also applicable to an IRS examination change. If an agent raised an issue concerning a change in an accounting practice, the taxpayer could request application of Revenue Procedure 64-16. In such event, the procedure was generally applicable to the most recent taxable year for which an income tax return had been filed. The availability of Revenue Procedure 64-16 tended to discourage agents from

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8 Skinner, *Inventory Valuation Problems,* 50 TAXES 748 (1972).

9 DeLeoleos, *IRS Drive on Improper Inventory Practice Foreseen: Consistency is Best Defense,* 15 J. TAX. 22 (1961); IRM 4231, AUDIT TECHNIQUE HANDBOOK FOR INTERNAL REVENUE AGENTS § 644-1.

10 Larkin & Showen, *How the IRS Is Handling Accounting Questions at the Agent and Audit Level Today,* 15 J. TAX. 194 (1961).

11 1964-1 C.B. 677.

raising the issue of possible changes in accounting practices, and inventory errors continued to be ignored.[12]

In September 1973 the Treasury moved to provide some specificity in the matter of inventory costing by the adoption of Treasury Regulation Section 1.471-11. The Regulations provide that all manufacturers must use the full absorption method of costing inventory in order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income. This means that in costing manufacturers' inventories, the direct materials, direct labor, and indirect production costs must be taken into account. There is no serious argument concerning the proper inclusion of direct material and direct labor costs. Therefore, the thrust of the Regulations is to categorize the indirect production costs into (1) those costs that are included in inventory, regardless of the taxpayer's treatment of those costs in its financial statements; (2) those costs that are not required to be included in inventory, regardless of the taxpayer's treatment of such costs in its statements; and (3) those costs that are to be included in or excluded from inventory in accordance with the taxpayer's treatment of those costs in its financial reports that are not inconsistent with generally accepted accounting principles.

These Regulations represent a move away from the traditional emphasis on consistency and the best accounting practice in a particular situation to that of imposing a specified inventory costing system on all manufacturers. The Regulations state that all manufacturing taxpayers not using the prescribed full absorption method must change to that method.

Although these Regulations will undoubtedly provide a greater degree of uniformity in the matter of costing manufacturers' inventories, they will also become the center of controversy concerning their interpretation and application. The problem of cost selection and the classification of specific expenditures are potential areas of controversy that will be particularly difficult for small business. Category (3) costs are to be treated as they are on the taxpayer's financial statements but only if this treatment is not inconsistent with generally accepted accounting principles. Of course, the specification of conformity with treatment on financial statements is meaningless for most small businesses. The financial statements can be made to conform to any desired end. The question of whether these financial statements are consistent with generally accepted accounting principles will be more difficult

[12] *See* discussion in Diamond, T.M. 303, ACCOUNTING METHODS-ADOPTION AND CHANGES § II. A.2.b.(2)(d) (1974).

to ascertain, since most small businesses do not have financial statements that have been audited by certified public accountants. The matter of cost allocation, that is, attaching the cost to product units, is also an area of potential controversy under Treasury Regulation Section 1.471-11 (d). These Regulations, however, should provide no new difficulties, since they adopt the standard of a fair apportionment while recognizing without limitation certain acceptable methods.

Although the full absorption inventory regulations are justified as conforming as nearly as may be possible to the best accounting practices, and the conformity requirements for category (3) costs would seem to indicate an Internal Revenue Service position that it is beneficial to equate income for tax purposes with income for financial reporting purposes, the Service is moving in the opposite direction in other areas. The new full absorption costing regulations for manufacturers do not cover an important valuation matter that relates to the problem of determining appropriate costs for inventory quantities in excess of prospective demand. The AICPA urged that the matter of inventory valuation under Sections 1.471-2 and 1.471-4 of the Regulations be dealt with, since a conformity test was being injected into the new Regulations and the Regulations did not conform to existing practices for financial statement purposes.[13] These matters were not dealt with in the new Regulations, but they are being dealt with in litigation. In *Thor Power Tool Company*,[14] the Commissioner contended, and the Seventh Circuit agreed, that inventory write-downs for excess stock were not permissible for tax purposes, even though the write-down constituted a "best accounting practice." Under Treasury Regulation Section 1.471-2, tax accounting for inventory must meet two standards: (1) it must conform to the best accounting practice used in the particular trade or business, and (2) it must result in a clear reflection of income. Although it would seem that conforming to the best accounting practice would clearly reflect income for financial purposes, it does not necessarily follow that this will clearly reflect income for tax purposes. And, how does one determine what clearly reflects income for tax purposes? The Seventh Circuit indicated that one first looks for a specific or general Regulation authorizing the inventory method. Failing this, the question is whether the Commissioner clearly abused his discretion. If the answer to this is negative, the Commissioner's determination will stand.

The matter of inventory write-downs for excess stock is not a unique or unusual problem but affects a great many taxpayers. The problem

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13 AICPA COMMENTS, *supra* note 7, at 4.

14 Thor Power Tool Co. v. Commissioner, 77-2 U.S. Tax Cas. 9658 (9th Cir. 1977).

is especially troublesome when items such as repair parts are carried to service obsolete models in greater numbers than indicated by customer needs. It seems clear that the Commissioner is only embracing generally accepted accounting principles on a selective basis. This will not make it any easier for taxpayers or their advisers to judge the proper application of Regulations.

LIFO Problems

In 1938, Congress amended the tax law to recognize the last-in first-out method of inventory costing as an acceptable method for processors of basic metals and tanners of hide. Then, in 1939 the law was amended to permit extension of the LIFO privilege to all industries. The new law, however, provided that (1) a taxpayer using LIFO must also use it for general financial reporting purposes, and (2) the LIFO basis could not be reduced for tax purposes through application of the conventional lower of cost or market rule.[15] At that time, LIFO had not been generally accepted for use by businesses for financial accounting purposes. Since inventories for tax purposes were to be costed on a basis conforming as nearly as possible to the best accounting practice and as most clearly reflecting income, it was logical to require the taxpayer and its accountants to sanction the method as being in accord with generally accepted accounting principles. The controversy within the accounting world concerning the acceptability of the LIFO costing method subsided by the late 1940's and early 1950's, and today it is clear that the LIFO method is a fully acceptable method of inventory costing. In light of today's inflation, it is considered by many to be the preferred method of inventory costing.[16]

Thus the reason for a conformity requirement no longer exists. Nevertheless, the Internal Revenue Service has continued to adopt a most restrictive view of the conformity requirement. In recent years, tax practitioners have watched an absolute parade of rulings march through their libraries concerning what can be disclosed in financial statements, how it can be disclosed, what departures can be made for financial purposes from those used for tax purposes, and so forth.[17]

[15] I.R.C. § 472.

[16] For a discussion of LIFO history, *see* H. Barden, *supra* note 4, at 85-96; Gertzman, *LIFO: Current Problems and Needed Changes*, New York University Thirty-Fourth Institute on Federal Taxation 235 (1976).

[17] Rev. Rul. 77-152, I.R.B. 1977-19, 19; Rev. Rul. 77-50, I.R.B. 1977-10, 6; Rev. Rul. 76-475, 1976-2 C.B. 139; Rev. Rul. 76-379, 1976-2 C.B. 138; Rev. Rul. 75-50, 1975-1 C.B. 152; Rev. Rul. 75-49, 1975-1 C.B. 151; Rev. Rul. 74-586, 1974-2 C.B. 156; Rev. Rul. 73-66, 1973-1 C.B. 218; Rev. Proc. 77-33, I.R.B. 1977-39, 25; Rev. Proc. 77-7, I.R.B. 1977-10,

Although these rulings have generally permitted disclosures and departures that have been required for financial statement purposes, the fact that the rulings are necessary is indicative of the IRS attitude and taxpayers' concern. The small businessman who frequently has had some suspicions of insanity in Washington has these suspicions confirmed when he is informed that in order to protect the LIFO inventory method he must exercise care in the preparation of financial statements and care in the disclosures that he makes to his banker.

The second condition to the use of the LIFO method for income tax purposes is the requirement that the LIFO inventories be stated at cost.[18] To the extent that inventories for prior years have been valued on a lower-than-cost-or-market basis and market write-downs have actually been effected, the amount of these write-downs must be restored to income. This restoration is accomplished by filing an amended return for the year preceding the year of the LIFO election.[19] The requirement for restoring market write-downs is a substantial deterrent to the adoption of LIFO for some taxpayers who may be very reluctant to incur the tax cost involved in such restoration. These difficulties were compounded when the Internal Revenue Service ruled that inventory write-downs for subnormal goods constituted "market" write-downs and must be restored to cost in the year preceding the year of change to LIFO.[20] Treasury Regulation Section 1.471-2(c) provides that subnormal goods should be valued for inventory purposes at bona fide selling prices less the direct cost of disposition, whether the cost basis valuation or the cost or market, whichever is lower, basis, is used. Consequently, it was contended that the write-down of subnormal goods was in accord with the cost basis valuation required for utilizing LIFO. The Internal Revenue Service did not choose to accept this interpretation, as has been pointed out. Under Revenue Procedure 76-28,[21] taxpayers were given a period of time to dispose of subnormal goods and on failure of disposition were required to write up their ending inventories. In this writer's experience, it is a rare inventory that does not contain some damaged, obsolete, or excess goods. In many instances, these items are simply not counted in the annual inventory taking. The requirement either to dispose of these inventories or to write them up to cost has a widespread impact on LIFO users and tends to force

11; Rev. Proc. 76-36, 1976-2 C.B. 659; Rev. Proc. 76-7, 1976-1 C.B. 546; Rev. Proc. 76-5, 1976-1 C.B. 543; Rev. Proc. 76-3, 1976-1 C.B. 542; Rev. Proc. 75-10, 1975-1 C.B. 651; Rev. Proc. 73-37, 1973-2 C.B. 501; Rev. Proc. 72-29, 1972-1 C.B. 757.

18 I.R.C. § 472 (b)(2).

19 Rev. Proc. 76-6, 1976-1 C.B. 545.

20 Rev. Proc. 76-282, 1976-2 C.B. 137; Rev. Proc. 76-28, 1976-2 C.B. 645.

21 1976-2 C.B. 645.

judgments concerning disposition based on tax considerations, rather than sound business reasons.

A third problem inhibiting the use of the LIFO inventory method for many taxpayers is the burdensome requirement of double-extending the inventory or developing an internal index. To date, the use of an external index has been authorized only for department stores and certain speciality stores using the retail method. Except for the authorized use of such an external index, many department stores would have found it practically impossible to calculate the LIFO value of inventory. Many other industry groups have similar problems, but Revenue Ruling 75-181 [22] has, for all practical purposes, eliminated the possibility of using external indexes in other industries. The ruling states that other taxpayers must develop their own internal indexes, unless they can independently demonstrate the accuracy, reliability, and suitability of use of an external index. Thus the Internal Revenue Service has continued its pattern of generally obstructing the use of the LIFO inventory method authorized by Section 472.

Conclusion

The accounting concepts of inventory pricing are broad general principles, within which a great diversity of practice is possible. In general, taxpayers' inventory costing methods for financial statement purposes have not been disturbed by examining agents. In addition, because of a reluctance to force changes that might result in certain income escaping taxation, the Internal Revenue Service has allowed a wide diversity of inventory practices, even though these practices might not be in accord with Treasury Regulations. Further, examining agents have been inhibited by the possibility of a taxpayer's election to spread the inventory adjustment forward to future years and by the fact that inventories are very difficult to verify at a date other than the year-end date. As a result, a great diversity of practice exists; and consistency is the one basic overriding principle.

In recent years, the Internal Revenue Service has moved toward providing more specificity in the inventory costing by stating in the Treasury Regulations *the* best accounting practice that will be recognized as clearly reflecting taxable income. This represents a general move away from the broad perimeters of generally accepted accounting principles to certain specified principles. In addition, the Commis-

[22] 1975-1 C.B. 150.

sioner, indicating a move away from the guidance of generally accepted accounting principles, has contended in litigation that the "best accounting practices" for financial statement purposes are not necessarily the "best accounting practices" for clearly reflecting income for tax purposes.

In the LIFO area, the trend has been to continue restrictive requirements seemingly designed to limit the ability to use the LIFO method of inventory costing.

In general, then, the trend seems to be toward more complexity and, specifically, toward required methods for tax purposes. In the area of permissible write-downs, the Commissioner's position seems unreasonable to businessmen. In addition, a spread forward is not now available for the inventory adjustment necessary on a manufacturer's change to the full absorption method. Should the examination of inventories be aggressively pursued on businesses that have historically been allowed to follow any consistent method, a great deal of controversy, if not chaos, should result.

SMALL BUSINESS PROBLEMS

Small business cuts across all industry lines and includes entities that vary greatly in size. It is of such a diverse nature that it has difficulty in presenting a unified proposal for legislative aid.[23] Its importance to the American way of life, however, can hardly be overemphasized. It constitutes the American dream of being your own boss and doing your own thing. The American economy is characterized by an innumerable multitude of small undertakings. The opportunity to begin or to engage in a small enterprise and the resulting spirit of individual enterprise has paid dividends in material wealth and national character. Small business, including individual inventors, has consistently accounted for more than half of all inventions.[24] Small business accounts for 55 per cent of the jobs in the private labor force, 48 per cent of all business output, and 43 per cent of the gross national product.[25] Much of the major growth in jobs is coming from emerging small technology companies.[26] According to the standards of the Small Business Administration (SBA), 97 per cent of all business enterprises are "small business." [27]

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23 Memorandum for the President, October 17, 1977, from Senator Gaylord Nelson, Chairman, Senate Select Committee on Small Business.

24 *Id.*

25 *Id.*

26 *Id.*

27 *Id.*

Because of the complexity, small business has great difficulty in (1) knowing that requirements exist, (2) understanding them, and (3) complying. The complexities of inventory pricing are difficult for all businesses. The complexity of the full absorption regulation, the LIFO conformity requirements, and the restriction on the use of indexing for LIFO purposes are aimed basically at large businesses. This is appropriate, since most of the dollar volume of inventory is held by these businesses; and they are able to cope with the most complex regulations and rulings. Technicalities, such as the conformity requirements, are not relevant or meaningful to small businesses and constitute only potential traps.

Since the term *small business* brings different pictures to the minds of different people, it will be helpful to consider a specific example in order to get a point of reference. The example will consider the inventory problems of a small manufacturer, very small in fact, with only 35 employees. This business is owned and managed by an individual with a university engineering degree and 10 years of experience with a large, publicly owned manufacturing concern prior to starting his own business. This small manufacturing concern may make parts for the automobile industry, the aerospace industry, the computer industry, or any one of a number of other industries. The owner, who we will call Mr. S. Business, constitutes the entire management team. He is the company and solves all its problems. Of the 35 employees, three are office employees who handle filing, secretarial, bookkeeping, and telephone answering services. One characteristic of the operation is its low overhead. In fact, the company is able to stay in business and compete because it is operated very efficiently with little waste of time or material. Mr. S. Business is very concerned about his overhead costs, which he calls "noncreative," since they do not become a part of the product he is making.

Payroll checks and the related records are prepared on the local bank's computer. Data concerning receipts, disbursements, accounts receivable, and accounts payable are forwarded each month to a computer center for processing into journals, ledgers, and monthly financial statements. No cost accounting system is maintained. Mr. S. Business has determined his costs by calculations he has made individually. He tests these calculations periodically as production continues. None of the cost information, however, is apparent from the basic accounting records. The company's chart of accounts provides for direct materials; direct labor; a series of accounts for manufacturing expense; and a series of accounts for general, administrative, and selling expense. No

allocations are made for a given expenditure. The rent, utilities, taxes, and insurance are all charged to manufacturing expense, since more than half are attributable to manufacturing space. The fact that part of these expenses are attributable to administrative activities is not considered, since it requires more bookkeeping to make these allocations, which means more expense that is nonproductive. Inventories on the financial statement remain constant and are changed only at year-end. All material purchases and direct labor are charged to direct costs. The monthly financial information does not consider the change in inventory; this does not matter, since Mr. S. Business knows whether his inventory position has changed, and he takes this into consideration in reviewing his monthly financial statement. In pricing the products, Mr. S. Business relies more on his judgment of what the traffic will bear than on multiples of cost, even though he always makes detailed estimates of the costs.

Most accountants would recommend some improvement in the company's recordkeeping system. Nevertheless, Mr. S. Business is able to successfully operate with a minimum of "paperwork," since he is personally involved with essentially all the activities of the company. If the company grows, responsibilities will have to be delegated to other persons; and he will need accounting controls and information flows to keep him advised. Mr. S. Business understands these facts very well. He purposely keeps his company small and never intends to grow because he understands that he can not successfully manage a large company.

Once a year, production operations in this plant are shut down for a few hours, and all employees count inventory. The first step is to organize the inventory for counting. When this is done, a number of items are placed in one corner of the plant. These include some damaged items of raw materials, scraps of various kinds, some components left over from a part that is no longer being produced, and so forth. These items are segregated because they are damaged or obsolete and have no value except for what can be obtained from a sale of scrap. In addition, there is a shed in the back of the plant that has boxes of some production overruns on parts that are no longer being produced. These parts were initially produced in case some of the parts delivered proved to be defective, and they are still kept on hand in case the customer needs a few more. This rarely happens, however. Normally, the obsolete materials and production overruns are retained at the plant on the outside chance that some use will be found for them. Periodically, when the plant storage space becomes cramped, a housecleaning

is made and the obsolete materials and production overruns are hauled to the junkyard and sold for scrap.

After the inventory preparations are completed, all the raw materials and finished parts are counted, the work in process is counted, and the stage of production is noted. The obsolete and damaged materials (cost of $1,000) and the production overruns (cost of $4,000) are not counted, since they are considered worthless. Office personnel then price the raw materials based on the latest invoice price, and Mr. S. Business estimates the material cost and labor in each production stage for the work in process and computes the cost of finished parts in a similar manner. This method of costing is known as "prime cost." Treasury Regulation Section 1.471-11 specifically states that this is not a permissible method, since Mr. S. Business has not included indirect manufacturing costs in computing the inventory costs. These costs could amount to as much as $10,000. Further, Treasury Regulation Section 1.471-2(f)(3) indicates that omitting a portion of the stock on hand is not permissible. Further, Revenue Procedure 77-228 [28] seems to indicate that production overruns must be included in inventory at cost.

Having absorbed a picture of a typical small manufacturer, the reader should now visualize the reaction of Mr. S. Business when he is informed about the full absorption regulations, the importance of pre-1954 inventory adjustments, the IRS's position on write-downs, the benefits and difficulties of LIFO, and the conformity requirements.

PROPOSALS FOR SIMPLIFICATION

Small Business Legislation

The preceding example is not a unique or unusual situation. There are probably 100 manufacturers similar to the one illustrated for every one of the large, publicly owned manufacturing concerns. The real problem suggested here is that a continued trend toward more and more complicated legislation and regulation in the tax area will make it increasingly difficult for the small businessman to cope with the rules. More and more frequently, he is considering the possibility of simply saying "to hell with it" and ignoring the rules and regulations. In this writer's opinion, the small business community has been ready to do this for many years; and the primary deterrent today is an army of ethical tax practitioners who are insisting on compliance, at least within reasonable tolerances. Care must be exercised to keep the complexities

[28] I.R.B. 1977-27, 13.

within the ability of the average practitioner. In the ERISA area, for instance, this ability is being stretched.

The possibility of providing separate tax legislation for small business should be given serious consideration. One of the difficulties with this proposal is the need to provide a definition for what constitutes "small business." Many definitions have been suggested. These generally relate to the amount of gross receipts, the number of employees, the size of equity capital, or number of stockholders. A study of small business, commissioned by the SBA,[29] has explored this problem and has suggested separate tax rules for a "small business enterprise" and a "medium business enterprise." A "small business enterprise" is defined by a limit on the number of shareholders, class of shareholders, the size of equity capital, the size of gross receipts, the type of gross receipts, and so forth. The "medium business enterprise" is defined by reference to the SBA's detailed size standards for qualification of firms for loans and SBIC assistance. It is suggested that the SBA definitions, which are lengthy and indicate size standards for at least 280 industry classifications based on the size of the gross receipts and the number of employees, are entirely too complex to be successfully utilized in a self-assessment system.

The Small Business Task Force of the AICPA Tax Division has been exploring this problem and is currently experimenting with the following definition of small business: an enterprise (proprietorship, partnership, or corporation) that is more than 50 per cent owned by "direct investors" and "employee investors" and that has not registered any securities under statutes administered by the Securities and Exchange Commission or made an offering of securities under "Regulation A." Further, the enterprise must not be a personal holding company or a partnership that if incorporated would be a personal holding company. A "direct investor" is an individual, a grantor trust of an individual, a decedent's estate, or a Small Business Investment Company that owns directly or by family attribution 10 per cent or more of the business enterprise. A qualifying "employee investor" is defined as an individual who would be eligible (except for minimum age) under ERISA rules to participate in a tax-qualified retirement plan of the employer. The theory is to provide small business benefits for those companies that do not have access to the public capital markets and that are owned by investors and employees who have a substantial stake in the enterprise. Admittedly, this definition would include a few

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29 M. Sampson, The Study of Small Business, Part III, The Impact of Taxation on Small Business: A Proposal for Reform (1977).

very large businesses. Also because of the stock ownership requirement, a few small businesses would not be included. This is considered an acceptable trade-off for simplicity and for the avoidance of transitional problems when companies move in and out of classification as a small business. Under the definition, companies would not normally lose the small business classification inadvertently. This would generally only happen as a result of a decision of the business to go public or to sell stock. Shareholder and employment agreements could protect all shareholders from inadvertent termination through a shareholder's sale of stock or an employee's termination of employment.

Small Business Inventories

Senator Nelson, chairman of the Senate Select Committee on Small Business, has, on several occasions, proposed to allow small businesses to expense inventories. Recently, this has been suggested for businesses with gross receipts not exceeding $1 to 2 million,[30] and previously it had been suggested for businesses with inventories that did not exceed $200,000.[31] Senator Nelson has stated that it is his understanding that the Internal Revenue Service does not object to such a proposal.[32] As for simplicity, nothing can be simpler than no inventory at all. It is difficult, however, to endorse a proposal that has so many possibilities for abuse. Businesses could eliminate their taxable income by acquiring inventory and would be encouraged to make decisions on inventory acquisition based on the tax ramifications, rather than on sound business principles.

It is suggested that the following is a more acceptable compromise:

(1) Allow prime costing for small business manufacturers

(2) Recognize write-downs on subnormal goods, including excess stock for both LIFO and FIFO costing

(3) Simplify the LIFO rules.

These changes would generally conform the existing rules to a small businessman's view of inventories. The principal benefit to retailers and wholesalers would be the general availability of LIFO.

Financial statement conformity requirements should be eliminated entirely. This is not relevant to small business, nor is it particularly meaningful to large business. As has been previously discussed, the

30 Note 23, *supra*.
31 S. 3397, 95th Cong., 1st. Sess. § 201 (1976).
32 Note 23, *supra*.

reason for the original adoption of the LIFO conformity requirement no longer exists.

The LIFO costing method should apply only to a company's stock of normal goods, and these goods should be valued at cost. Only normal goods should be included in the LIFO pools under the dollar value method. Subnormal goods should be treated separately and removed from the LIFO pools as if sold and valued at net realizable values. The definition of subnormal goods should include items of excess stock and production overruns that are not saleable in the normal pattern of the business.

LIFO Indexing

The complexity of LIFO calculations creates a bias against small business that is unacceptable in the fair administration of tax laws. There are valid reasons why LIFO should be generally available to small business.

LIFO developed as a substitute for the base stock inventory method, since this method was not recognized as proper for tax purposes.[33] The theory of the base stock method is that a quantity of inventory considered by management to represent the minimum base for effective operation is treated for accounting purposes in much the same manner as a fixed asset. The base quantity is carried forward from year to year at its original cost or at some arbitrary nominal cost. Deficiencies in base quantities at the end of a year are usually considered temporary, and reserves are provided for anticipated excess costs of replacement over the amount at which the product would have been included if the base quantities had been maintained. Thus the earnings of a period in which temporary reductions occur are not affected by either the temporary liquidation or the replacement of the base stock quantities. Inventory quantities in excess of the base stock are carried at current costs. Use of the method prevented a distortion of current income as a result of price increases or decreases in the base stock quantity. Inventory was thus treated very much like a fixed asset.

During times of inflation, capital burdens are accentuated under FIFO costing methods because this in effect results in a requirement to pay income taxes on the appreciation in value of the basic level of inventory necessary for the operation of the business. The LIFO inventory method tends to prevent this, and it is an important tool that

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33 H. Barden, *supra* note 4, at 85-86; *Lucas v. Kansas City Structural Steel Co.*, 281 U.S. 264 (1930).

should be available in order to aid the capital needs of small businesses. LIFO could easily be simplified by allowing the use of externally developed indexes, such as has been done for the department store industry.[34] It would seem that the Internal Revenue Service and other agencies and departments of the United States Government have the best tools available from which to develop these indexes. It should be recognized that these indexes cannot be perfect; but although they might not produce the right answer for any given year or any given business, they will, over a period of time, tend to provide a proper result. Taxpayers having adopted the method of using an externally approved index would be required to continue using that method. The exactness of the double-extension method would be sacrificed in the quest for simplicity.

34 American Institute of Certified Public Accountants, Recommended Tax Law Changes 48 (1977).

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Simplification for Agricultural Taxpayers

John C. O'Byrne

Secretary of the Treasury William E. Simon, in the foreword to *Blueprints for Basic Tax Reform,* said that he was convinced that tinkering with the tax system is no longer the answer. He called for an entirely new system. Others in our gathering have given attention to grand new plans. I would like to examine some of the problems of simplification that might be mitigated by some "untinkering" with the present system at the same time that we push for massive reform.

I am not suggesting that I am against tax reform in the grand manner or that I despair of simplification on the grand scale. But I am old enough to remember that Wilbur Mills told us that the 1954 Code was a tax simplification. Mark me as a happy cynic, eager for the promise of a magnificent new system but also concerned about the improvement of the existing world.

My 95-cent dictionary defines the word "simple" as "uncomplicated; easy to do or understand," which is what I want to talk about. The word also means "stupid or foolish," which I may prove to be. The dictionary defines "complex" as "complicated," which, in turn, is defined as "intricately involved, hard to solve." That is about right.

I was fascinated and delighted to see the developing consensus at our conference. I found that I concurred with the comments of Professor Schenk, Dean Griswold, Jim Lewis, Ward Hussey, and Commissioner Kurtz. Each seems to sense that there is a pragmatic arena of simplification that can aid compliance. I think that we are all suggesting that efforts toward simplification begin simply in noncontroversial areas, that simplification be divorced from tax reform, and that we first push forward on the present Code. I hold the brief for massive simplification by the elimination of capital gains and the integration of

* John C. O'Byrne is a Professor of Law at the University of Georgia School of Law, Athens, Georgia.

corporate taxes and maybe even the comprehensive tax base. But now I join my colleagues in advocating simple simplification as our initial effort.

Compliance problems are not new to Service personnel. They have been working on small business compliance for a long time. Apparently, they regard the compliance level as low.

If my readings are right, they have found that the taxpayer's costs of full compliance are high (for example, the costs of recordkeeping and tax counsel), maybe even higher than the tax to be collected. I detect that the cost of auditing is not worth the revenue, but the psychological effect of nonfiling is troublesome. I submit that simplification is one of the roads to improved compliance.

ORIENTATION TO GRASS ROOTS

I purport to represent two special groups of people: reasonably successful farmer taxpayers, and their tax return preparers, reasonably successful lawyers who fill out farm income tax returns and who advise farmers. These are lawyers who regard income taxation as the general practice of law. It is a solid middle-class group that is very tax aware, higher in the tax pyramid than Professor Schenk's taxpayers, but still low in the pyramid. I am one of them in the sense that much of my experience has been with those who struggle with ordinary tax problems, that is, new students, farmers, and lawyers in small towns. To much of the sophisticated tax bar, we may very well be described as lay persons. I like to think of us as taxpayers, tax preparers, and tax advisers struggling to be "semisophisticated."

A quick history may offer some insight into what follows. I went to Iowa 30 years ago and taught tax to law students, most of whom entered small town practice. Sometime later, I met a lawyer from Oskaloosa who had prepared a pamphlet on Farmer's Income Taxes to aid his colleagues who made out farm income tax returns. I joined my Oskaloosan colleague in his endeavor and we produced the book *Farm Income Tax Manual*. He died in 1956, and I continued the *Manual*, which is supplemented annually and is now in its fifth edition. The purpose has not changed: it is still designed to help return preparers do a good job fast. In addition, I have participated in continuing legal education at the grass roots level, have spent many years on the madhouse assembly line turning out tax returns (maybe before H&R Block), and have had a continuing association with farmers, small town lawyers and accountants, and farm extension people, who

long ago discovered that income taxes were an important part of farm economics. It is not hard to understand my orientation to farmers who have tax problems and to their tax return preparers and tax advisers.

In dealing with income tax at this level for over 30 years, I have become acutely aware of the steadily growing complexity, which was happening long before our recent worries about tax shelters and tax reform. For the first 20 years or so, there was a feeling on the part of both farmers and return preparers that they could hold onto and absorb the steady accretion of tax rules. By participating in annual study and continuing education programs, they felt that they were keeping up. More recently, however—perhaps the turning point was the Tax Reform Act of 1969—I have found among the preparers and advisers a developing sense of despair, an uneasy worry about the quality of service, an insecurity about their knowledge, and a feeling of restlessness.

Remember, I am not talking about corporate reorganizations, shopping centers, tax shelters, or other big deals. I am talking about the simple business of preparing a tax return for a farmer who operates a moderately successful farm business.

I fully agree with Professor Schenk that we must be concerned with tax return preparers. It is interesting that in our original papers we reached similar conclusions without collaboration or even acquaintance. The difference in experience is that Professor Schenk's universe involves taxpayers with lower incomes and less complicated businesses than those that I purport to represent. The difference in philosophy is that she has reached a level of despair that I, as an older citizen, have not yet reached. But her warning about the importance of tax preparers must not be ignored. And I suggest that our disparate experiences that have led to similar conclusions warrant serious consideration.

WHO ARE FARM TAXPAYERS?

There are at least five levels of farmers to whom our attention could be directed:

(1) Hobby or residential farmers whose farm businesses raise issues of squabbly facts.

(2) Small but real farmers who just scrape by and probably do not generate enough income to concern the Service, although nonfiling may be a problem.

(3) Substantial commercial farmers who do make money and who have substantial farm investment but few employees.

(4) Very large farm operations, possibly incorporated, that are regularly audited and well advised.

(5) Urban cowboys and the tax shelter seekers who get plenty of attention and little sympathy.

I want to direct our attention to Group 3, the successful farmers who make money from time to time, have a substantial investment in their farms, and worry about income taxes.

FARM TAXPAYERS AND RETURN PREPARERS

I will tell you herein what I think at the current time. I could be terribly wrong in my perceptions and my premises. As an academic, I know well that an academic who starts his colloquy with the words, "I could be wrong," is sure he is not. But I beg you to accept my professed doubts at face value. I have been close to farmer taxpayers and return preparers at some times and distant at others. There may be a "halo effect" because farmer taxpayers and farmer's lawyers are people I like.

My premise is that these farmers and return preparers are generally honest and try to file correct returns. Will the benefit of the doubt go to the taxpayer? Of course. But will they walk the ragged edge of fraud? No.

Over and above a basic integrity, there are other factors that tend to keep farmers and preparers more, rather than less, honest. A few audits in an area are effective. The Service used to, and I presume still does, audit farmers in such a way that a gentle aura of publicity floats through a county. A little audit activity keeps taxpayers from loose rationalizations, and it is fine for business in small law offices because additional taxpayers turn to professional help.

But audits are also troublesome. A return preparer is supposed (by his client) to know how to make out a return. If the return bounces, it is hard for the client to understand why he should pay additional fees. He has already paid to have his return prepared. Thus practitioners are cautious about disputed positions and, on balance, tend to follow IRS instructions to avoid unpaid or low-paid audit time. If there is a reasonable possibility of challenge, a careful practitioner will talk the issue out with his client before the return is filed. At this stage, if there is a reasonably clear Service position, the client is likely to back away from potential conflict.

It seems apparent, too, that a taxpayer and a return preparer are

comfortable with rules that have a theory that the taxpayer and preparer can understand and easily apply. In fact, in many cases, they apply the theory without much concern for the rule. For example, the theory of straight-line depreciation is easy, and it will carry over to an understanding of fast depreciation methods. The average farmer understands perfectly well how he can spread his cost recovery over the life of a machine. ADR is rarely used by my people, probably because it seems to be all nitty-gritty rules and too much accounting. Recapture of depreciation on machinery is theoretically easy, quickly understood, and passes at once into the planning and compliance skills of farmer and practitioner. Section 1245 illustrates a reform that was incorporated into the return preparer's job with little difficulty. Contrast the recapture provisions of Sections 1250 (real estate), 1251 (excess deductions account), and 1252 (land expenses), which add considerable time and complexity to return preparation.

Let me offer a partnership example. It seems easy for farmers and preparers to understand the theory of Section 751, which converts unrealized receivables and appreciated inventory into ordinary income on the sale of a partnership interest. There is a sensible logic to the rule. In contrast, the theory of the Section 754 basis election apparently is very difficult to grasp, maybe because the mechanics blur the theory. Interestingly enough, I think many lawyers were reaching the election result (without an election) because they had a theory that a buyer or an estate always had a basis of cost or fair market value at death, so they adjusted the partnership figures to give the new partner the benefit of a new basis.

Further, there is a high possibility of error in those situations in which the theories behind handling similar transactions are very much the same, but the detailed rules are different. For example, it is not hard to understand that land improvements are ordinarily capital expenditures. But the system breeds complexity and error when the deduction for soil and water conservation expenditures is limited by a percentage of *gross* income from farming and may be carried forward; the deduction for land clearing is limited to a percentage of *taxable* income from farming and may not be carried forward; and the deduction for fertilizer that produces benefits in future years is not limited at all.

The conclusion that I draw from these observations is that simplification directed toward the return preparer adds legions of enforcers of compliance because, on balance, return preparers will do what they are told if they understand what they are doing, and they will try to avoid conflict, if possible.

While I was redoing this piece, I had calls from two lawyers preparing tax returns, one from a big, fancy firm in Georgia, one from a tiny town in Wisconsin. Both were concerned with the basics of the investment credit. One queried whether the investment credit was recaptured in the Section 736(b) payments to a retired partner, the other queried whether the heir who purchased property from an estate could claim the investment credit as an unrelated buyer. Both had done their homework and had found no answer. Both wanted the best answer for the client, but both wanted to be sure that they advised properly in circumstances in which they found no statute, regulation, or commentator to offer direct guidance. They went out of their respective ways to do the job right, and they made their decisions on the basis of their theories on the application of the investment credit. One concluded in favor of the government, and one decided partially in favor of his client and partially in favor of the government. These are the people upon whom the compliance structure depends.

Many years ago, I read a book by Aubrey Mears (a very early official of the Bureau of Internal Revenue) called, if I remember correctly, *Reflections of a Revenuer*. In it, I first discovered that as one works for the Service, concerned primarily with the taxpayers who cheat, it is easy to regard all taxpayers as cheaters. I then understood that "to the jaundiced eye, all the world is yellow."

But is it true? Am I wrong in my belief that a very large percentage of ordinary taxpayers and preparers are more or less honest with the system and that much of the "more or less" is tolerable?

GRASS ROOTS ADMINISTRATION

There is a form of simplification that can be developed administratively. A substantial amount of tax law used by the farmer and the return preparer is Service law. Compliance is better served by rules that are easy to apply and that do not appear to be arbitrary. Our friend Bittker's "law of the lifted eyebrow" works at the grass roots, as well as in reorganization practice.

I took a degree once upon a time in Public Administration, and I have administered little things. Even in the small bodies, it is clear that there is a need for rules. It is also clear that the administrator too often seeks rules that are tidy and that get things done quickly. It is easy to forget the problems of the troops who must comply with the rule and who may, for one reason or another, fail to dot all the i's or fail to make it on time.

The Service can aid in simplification and divert taxpayer hostility if its procedural rules can offer some slack to ordinary taxpayers. I think, for example, of the squabbles about the installment sale election being made on a timely filed income tax return. The issue should have been: Would there be a substantial revenue loss if the election could be made within the statute of limitations?

I was troubled last year by *Jones v. United States*, 553 F.2d 667 (Ct. Cl. 1977). An estate's partnership interest represented low-basis real estate and cattle. The executor claimed an upward adjustment of basis on the fiduciary return as if a Section 754 basis election had been made. No election was filed with the partnership return that covered the year in which the estate first needed the basis. The court upheld the requirement of Treas. Reg. § 1.754-1(b) of a timely filed election.

The facts of the case suggest that the executor applied theory to increase basis and, perhaps, was not even aware of the technicalities (or, maybe, even the existence) of Section 754. The absence of the election was picked up in an audit of the fiduciary return. In any event, there was ragged practice or lack of information. The result was a loss of a substantive benefit that the taxpayer could have had if the procedural screws had been turned. There should be a way to salvage the substance in a case where only the procedure is at fault. The substantive loss of benefit is too great a punishment for the procedural sin.

The data content of election statements might be reexamined to be sure that the taxpayer is being asked only for necessary information. As the Commission on Federal Paperwork suggests, unnecessary aggravation destroys compliance. I am, of course, less troubled by the election data requirements if there is a chance to correct the filing.

Long-time tight rules have been loosened. We are not without precedents. For example, a taxpayer may now have an automatic extension of time to file a return; previously, the extension was permissive. It will be interesting to know how this relaxation has worked out.

We need not be concerned at the moment with whether the procedural rule is statutory or administrative. The question is: Would relaxation of procedural rules or time limits in specific cases aid simplification? One illustration of recent statutory relaxation is the extension of time to replace property after condemnation from two years to three years. I.R.C. § 1033(f)(4).

I use the election examples because they were brought to mind by the *Jones* case and by the new regulations under Section 451, which allow postponement of gain on excess sales of cattle because of drought. Our attention, however, should be directed to any circumstance in

which failure to meet a procedural rule will deny a substantive benefit. Compliance should be made as easy as possible.

Condemnation and involuntary conversions generally offer a little piece of Service law that could be reviewed for simplicity's sake. The accretion of finicky rules over time has been substantial. Even a knowledgeable and cautious practitioner must be wary of the replacement and timing rules.

Technical (and, perhaps, correct) decisions by the Service can create aggravation without important revenue return. Decisions of this nature have been turning up in the farm area lately. It sometimes seems that a theoretically ordered system takes precedence over reality. Some examples will illustrate.

A farmer may file an annual declaration of estimated tax; if the return is filed by March 1, no declaration is required. But to so qualify, two thirds of the gross income must come from farming. I.R.C. §§ 6015, 6073, 6153. Sales of capital gain livestock are treated as farm income, but sales of farm land and farm machinery do not produce farm income. Rev. Rul. 63-26, 1963-1 C.B. 295. That is a technical distinction that farmers and return preparers cannot theorize. If the two-thirds test is not met, the penalty is 7 per cent interest on each quarterly installment missed. I use this example to illustrate what my preparer friends would regard as technical nonsense and to suggest that the cause of simplicity might be aided if we reexamined the premise that the sale of a bull is farm income, but the sale of a combine or the "back forty" is not.

Suppose a farm husband worked the farm and the wife taught school. If her income was 35 per cent of the total gross income of the couple, they could be liable for penalties if they failed to file quarterly declarations of estimated tax. If they filed a joint return before March 1, they would not be free of the declaration requirement and penalties because only 65 per cent of the joint income was from farming. If they filed separate returns, she would not be subject to penalty if withholding on her wages was sufficient, and he would have no penalty because all of his gross income was farm income. Rev. Rul. 75-356, 1975-2 C.B. 497.

We speak often of "traps for the unwary." Pogo would be right if he suggested that we are all unwary in some tax determinations. It is important to recognize that much of our needed compliance comes from those of us who are unwary at one time or another and that one step toward simplicity is an effort to eliminate the traps. I suggest an analysis of administrative rules, particularly procedural rules, to see if the conflict between enforcement and simplicity (and maybe fairness) can be resolved in favor of more simplicity.

The Treasury has done an excellent job in trying to simplify reporting by the average taxpayer. The forms have steadily improved. The tax tables for 1977 are a great advance. The explanatory pamphlets, including the *Farmers' Tax Guide,* are excellent.

The same approach should work in rule simplification. And, to the extent that the Service does not think that it has authority to act, it will have identified the problems for the application of its "reverse legislation" theory. After every major revenue act, we have some form of Technical Corrections Act to smooth out problems that were not foreseen. Perhaps we could encourage a Tax Simplification Bill to remove the kinks from established law.

RULES AND TOLERANCES

In many tax areas, rigidity of rule is accepted without much fuss. Taxpayers do not fight the long-term capital gain rules. They may moan or try an innovative counting rule, but the former has no impact and the latter is rare. In the farm area, the adoption of the 12-month and 24-month holding periods on draft, breeding, dairy, and sporting livestock added certainty of rule and substantially reduced conflicts.

There is a lesson in the history of Section 1231(b)(3) and its predecessor, Section 117(j), which treated draft, breeding, and dairy (and, later, sporting) livestock as property used in the trade or business. In the litigation over whether an animal was held for the required purpose, the Service tried to develop an age test without much success. Then, Congress moved into the fray and established a special holding period. The rule did cut down squabbles. I think it worked because the period adopted was close to the real world period of maturity of the animals.

I mention this real world relationship because I have recently talked to a taxpayer who made an "unreal world" complaint. The issue involves the useful life of pecan trees. According to my angry troop, an agent has heard of a producing tree that is 140 years old, and he therefore holds to a useful life of 140 years for the taxpayers' trees. There are no published guideline lives for trees, vines, and orchards. Nonetheless, there must be acceptable periods or ranges of useful lives that can terminate squabbles. Perhaps the agricultural schools have data to establish periods that would serve as guidelines on trees and vines.

Where the Service has established useful lives, it has lessened controversy. The 1942 Bulletin F, Revenue Procedure 62-21, 1962-2 C.B. 418, and Revenue Procedure 72-10, 1972-1 C.B. 721, establishing acceptable useful lives, had the effect of granting the taxpayer a "safe haven."

Revenue Procedure 72-10 was not designed for general guidance, but was part of the Asset Depreciation Range system for those taxpayers who elected it; however, it had the effect of serving as a useful life guide to taxpayers generally. The "safe haven" is vital to the small taxpayer who wants the best deal without a fight and without cheating.

Taxpayers are concerned with those same problems that the IRS sees as troublesome. Among other concerns, the Service worries about the allocation between personal and business use and the problem of current expense or capital expenditure. So do farmers.

In making out farm tax returns, there is always a form of guesstimate involved in deciding how much business use to claim for a car. A geographical area tends to develop a common law. For example, if a farmer has two cars in one area at one time, one will be claimed as the business car. There will be some, but not much, discussion about whether 50 per cent of the other car should be claimed. If the farmer had a pick-up truck, it would clearly be for business purposes, and the preparer would then guess how much of the car expense could be justified as a business deduction. The issue is an obvious one to raise on audit.

Very often, a farmer (or his spouse) did farm work (records, bookkeeping, reading, planning) in the house and claimed that part of the residence as used for business purposes. If he or she used the kitchen or the family room, the allocation of expense was pretty ragged. If there was a separate office, the allocation was more reasonable. In either case, the deduction generated a squabble on audit.

Allocation to expense or capital expenditure has been troublesome. The general rule is clearly that the cost of an asset that lasts more than a year is a capital asset. But there has to be a *de minimis* toleration point, or the depreciation recordkeeping would be horrendous. For example, the basis for *Gaddis v. United States*, 330 F. Supp. 741 (S.D. Miss. 1971), is ridiculous. The government challenged something over $11,000 of supplies bought for use on 70 chicken farms that turned out five broiler cycles a year. No item cost more than $8.51. Very often, the toleration point is set by the taxpayer, for example, any item that cost less than $100 is deducted. Sometimes, he learns acceptable rules of thumb from revenue agents.

These kinds of things are hard to simplify. Nevertheless, the effort should be made to determine what issues are troublesome on audits and whether there can be a toleration level that will eliminate the common ones.

I have noted Meade Emory's reference to former Commissioner Alexander's fear that tolerances or guides would be a "roadmap to tax evasion." Maybe the fear is overstated; and, perhaps, guidelines, or even "threat-lines," can provide greater certainty that, in turn, will aid simplification.

Sometimes the simplification comes with a heavy hand. For example, Section 280A eliminated home use deductions for farmers who worked in the kitchen but not for farmers who worked in a den that was the "exclusive" office. That clearly created certainty for the taxpayer with the smaller house. Section 263(e) authorized the Service to establish toleration limits on repairs, which became the ADR repair allowance. It was a good idea, but the ADR rules were so complex that the opportunity was ignored by many taxpayers. See Treas. Reg. § 1.167(a)-11(d)(2).

Much guidance can come from the Service, formally or informally. Guides are more likely to be formal, but if they are on a national basis their utility is low. Tolerances, I suppose, tend to be informal. We could experiment to see if guidelines or ranges or tolerances would serve the cause of simplification without serious sacrifice of revenue.

If the Service does not offer guidance, others will. For example, I recall placing two similar bits of advice in the *Farm Income Tax Manual.* At one time, two issues were "hot," salvage value and family consumption of farm-produced food. These were regarded as nonsense issues by farm taxpayers, who were at least half right. But the issues arose on audit so we gave this advice: Show a minimum salvage value and reduce farm deductions by a minimal amount. The argument was that if no figures were shown, the issues were matters of principle and the taxpayer was wrong; but if he showed some figure, the issue, if it arose, was merely a squabble over very "iffy" facts. This is game playing, and game playing leads to more game playing.

The salvage value issue led to Section 167(f), a statutory tolerance. This section, however, did not cover livestock, a big salvage value issue for farmers, so the game continued. Of course, as Section 1245 on recapture of depreciation took hold, salvage value became less important to auditing agents.

The goal is to indicate to taxpayers that there are acceptable limits that do not trigger audits and to suggest the range of IRS concern. The Service should not make the limits too tight, which also creates hostility. The Service often rules too tightly, probably in its zeal to protect the revenue. Does it reap bitterness not recompensed in dollars? Are not the sales tax and gas tax tables overly conservative?

It may be that the guides or limits will have to be worked out within districts or within even smaller geographical areas that have homogeneity of production. I would not be surprised to learn that many such guides already exist for auditing agents in farm areas.

It is not easy to develop guidelines, but I think that it is worth further experimentation in the clear and simple areas of factual conflict. If guidelines compliance ease and add greater certainty to simple tax planning, there is an additional reward of reduced costs to taxpayers and the Service.

STATUTORY DIFFERENCES

Provisions of the Code enacted at different times and, perhaps, for different purposes may come together in the taxpayer's return and add tremendous complexity. Consider the panoply of depreciation, investment credit, and recapture.

In the *Farm Income Tax Manual,* we tried to chart the rules to offer a summary guide to practitioners. The charts appear on pages 432–435. Could these rules be simplified? Are there current policy reasons for the great differences in detail? Could those sections that are designed to encourage investment be coordinated to simplify tax management and reporting by taxpayers?

Consider another, narrower, example of sections based on similar theories but with disparate rules. Soil and water conservation and land-clearing expenses are ordinarily treated as capital expenditures added to the basis of the land. But Sections 179 and 182 allow some of these expenses to be deducted at the election of the farmer. Soil and water conservation expenses may be deducted up to 25 per cent of *gross* income from farming, and the excess may be carried forward to be deducted in later years. Land-clearing expenses may be deducted in an amount up to $5,000 or 25 per cent of *taxable* income from farming, but there is no carry forward. The recapture rules are the same. Costs of fertilizer that produce benefits lasting more than a year can be deducted upon the election of the taxpayer without limit under Section 180, and there is no recapture. The soil and water expense election is permanent; the other elections relate only to the current year. Why should the ground rules be so different? Is there a substantial revenue policy behind the differences?

Can we develop an analytical process to examine Code sections that affect particular groups of taxpayers to determine whether different

rules articulate substantially different policies or whether the rules were drafted by different persons at different times? The preceding examples are obvious; there are many others.

SUBCHAPTER S EXPERIENCE

A lesson in statutory simplification is found in the Subchapter S experience. But the simplification has been slow, limited, and uncoordinated. The entire Subchapter S should be regularly reviewed to see if its complex rules are necessary to its purpose and if experience proves a need for continuation of the complex rules for a structure that was touted in 1958 as a boon for small business.

The Subchapter S corporation offers a classic example of a simple idea that was embedded in statutory provisions too complex for its beneficiaries to manage. The Tax Reform Act of 1976 showed that we can back away from complexity that causes harm. The Tax Reform Act amendments, changing the positive election to a negative refusal, permitting stock to be held in a grantor or voting trust, and offering some disposal time to a testamentary trust, were steps in the right direction. But it took almost 20 years. And Subchapter S is still an incredibly complex beast to loose on unsuspecting small businesses.

The latest development is the Carter proposals, which would increase the allowable number of shareholders to 15, allow a testamentary trust to hold stock, expand the election time limits, and provide a form of loss carryforward. These would be progress toward simplification.

Progress would be greater if Subchapter S was thoroughly reexamined in the light of its potential traps for the unwary to see if the policy of the statute could be adjusted to reduce the risks to taxpayers. For example, is there a substantial revenue principle involved in the rule that previously taxed income of a shareholder does not pass to a donee or a decedent's successor? Do we really need to inject "earnings and profits" notions into this hybrid? Why hold to one class of stock? Our philosophy of the Subchapter S corporation is ragged. Do we see the Subchapter S corporation as a partnership with corporate attributes or as a corporation "taxed like a partnership"? The analogues push in different directions. The corporate analogue has caused much trouble; perhaps the partnership analogue would serve better. Maybe simplification would be best served by scrapping both analogues and by creating a small business corporation that could be understood by the people who run it.

QUICK REFERENCE CHART TO

	Property	Useful Life	Basis
	See § 507	See § 509	See § 511
Additional First-Year Depreciation (election) See § 503	Tangible personal property purchased, new or used. Purchases from "related" persons do not qualify.	6 years or more.	Cost. Does not apply to property acquired by death or gift or which has basis of transferor.
Ordinary Depreciation (mandatory) See § 505	All depreciable property, new or used.	Over 1 year.	Adjusted basis reduced by 20% additional first year depreciation and salvage.
Fast Depreciation (election) See § 505	Depreciable tangible property; original use must commence with taxpayer. Not available on real estate except residential rental housing.	3 years or more.	Same; except no salvage for declining-balance. But see ADR rules.
Reduction of Salvage (election) See § 510	Depreciable personal property. Excludes livestock.	3 years or more.	Cost or other adjusted basis.
Asset Depreciation Range ADR	§ 1245 property § 1250 property See more detailed rules at § 509 Post-1970 acquisitions new or used.		Cost reduced by 20% additional first year depreciation. Salvage value may be ignored, but no account may be depreciated below salvage value.
Class Life System	Pre-1971 acquisitions.		Effort to permit something similar to ADR for pre-1971 acquisitions. See § 509.

RULES ON CLAIMING DEPRECIATION

Method	Exchanges	Limitations	Special Rules
	See § 346		
One time deduction—up to 20% of cost.	Applies only to cash boot paid.	$4000 deduction per year on joint return; $2000 on others.	Taken only in first year of regular depreciation. Does not apply to trusts.
Straight-line, 150% declining balance.	Use basis of property acquired, usually basis of old plus boot.	Only 150% declining-balance on new buildings. Only straight-line on used buildings. Residential rental units have special rules.	Salvage value recognized except under declining-balance, but see ADR rules below. On personal property (except livestock), ignore salvage up to 10% of cost or other basis.
Double declining-balance, sum-of digits and any other not faster than double declining-balance.	Use basis of property acquired. New property only.	Not allowed on buildings. Residential rentals have special rules.	Change from double declining-balance to straight-line at will; otherwise, method may not be changed without permission. But see ADR rules below.
Reduce salvage value by 10% of cost or other basis.	Use basis of property acquired.	None.	Salvage is estimated sale price at end of taxpayer's normal period of use of asset. But see ADR rules below for more liberal rules.
Straight-line, declining-balance, sum-of-year digits, but not units of production.			May elect repair allowance described at § 402. May change declining-balance method to S-Y-D or from declining-balance or S-Y-D to straight line without consent of Commissioner. Choice of half-year or modified half-year convention. Salvage value not adjusted unless more than 10% in error after taking into account 10% allowed under election described at § 510.

QUICK REFERENCE CHART

	What Recaptured	Amount Recaptured
Recapture of Depreciation on Property other than Real Estate. IRC Sec. 1245 See § 514	Depreciation claimed on tangible and intangible personal property and other tangible property used in farming or for farm storage or research (except buildings). Includes livestock after 1969.	Lesser of gain or depreciation after 1961 (livestock after 1969).
Recapture of Depreciation on Real Estate deducted before 1970. IRC Sec. 1250 See § 515	Excess of fast depreciation over straight-line claimed on buildings and other realty not included under Sec. 1245 above.	"Applicable percentage" of lesser of gain or excess depreciation from 1964 through 1969.
Recapture of Depreciation on Real Estate deducted after 1969. IRC Sec. 1250 See § 515	Same as above.	Lesser of gain or excess depreciation claimed after 1969.
Recapture of Land Expenditures. IRC Sec. 1252 See § 517	Soil and water conservation expense deductions under Sec. 175 and land-clearing expense deductions under Sec. 182.	Lesser of gain or percentage of land expense deductions based on period land was owned.
Recapture of Farm Losses in Excess Deductions Account (EDA). IRC Sec. 1251 See § 516	Accumulated farm losses of individuals and Subchapter S corporations in excess of $25,000 in years in which nonfarm income exceeds $50,000. All farm losses of corporation, estate or trust. No additions will be made to this account in years commencing after 1975.	Lesser of gain on "farm recapture property" or balance in EDA. Only land deductions for 5 years on sale of land.
Recapture of Investment Credit. IRC Sec. 47 See § 518 *	"Unearned" credit claimed on tangible personal property (includes livestock, other than horses) and other tangible property used in farming or for farm storage or research (except buildings) with useful life of 3 years or more.	Difference between credit claimed and credit based on period property held is added to tax.

* Rules applicable to investment credit in effect prior to April 18, 1969, are omitted. They do differ in some minor details.

TO RULES ON RECAPTURE

Special Rules	Tax-Free Exchanges	Death, Gift, Other
Gain not recaptured is Sec. 1231 or capital gain. Subject to EDA recapture. See below.	Recapture limited to recognized gain plus value of nondepreciable property not treated as gain. Potential recapture carries over to new property.	No recapture on death; no pre-1977 carry-over. No income on gift, but donee succeeds to recapture. Charitable gift reduced by recapturable depreciation.
"Applicable percentage" is 100% reduced by one percentage point for every month over 20 that property was held. No recapture if held over 10 years. Gain not recaptured is Sec. 1231 or capital gain. Post-1969 excess depreciation is recaptured first. Not subject to EDA recapture. See below.	Same as above.	Same as above. No recapture on residence except part used for business.
Post-1969 excess depreciation is recaptured before 1963-69 excess depreciation. See above. Residential rental units receive more liberal treatment. Gain not recaptured is Sec. 1231 or capital gain. Not subject to EDA recapture. See below.	Same as above.	Same as above.
Per cent of deductions recaptured if land held: 10 years ....none 9 years ....20% 8 years ....40% 7 years ....60% 6 years ....80% 5 years or less ....100% EDA recapture applies first.	Same as above.	Same as above. Allocation on sale of part of land.
Farm recapture property is depreciable property, livestock, unharvested crops and land under Sec. 1231, but not buildings. EDA is increased by losses, reduced by farm income and amounts recaptured.	Same as above; except special rules for formation of corporation and partnership.	No recapture on death; no carry-over to estate. On gift, if potential gain on property given exceeds 25% of potential gain on property of donor, donee succeeds to proportionate share of donor's EDA.
Applies to casualties and thefts.	Recapture on exchange, involuntary conversion; not on mere change of business form.	Recapture on gift; not on death. Recapture if business use ceases.

Partnerships and Subchapter S corporations are supposed to be the business organizations of small business; however, Subchapters K and S have become the source of complexity. It just does not make sense for these devices to be more complex than an ordinary Subchapter C corporation.

One final point of this diatribe. If you look at the amendments to Subchapter S (and Subchapter K, for that matter), they are, for the most part, "anti-hanky-panky" provisions. The impetus was fear of abuse by the few, rather than adaptability to the many.

PRE-CONCLUSION

There is an old farm joke about the book salesman who was trying to sell a crochety farmer a book on how to farm better. The farmer refused to buy the book because he already knew how to farm better than he farmed. It is literally true in the farm extension and land-grant university world that there is more technical knowledge available than is being effectively used. Perhaps the same can be said of us in our search for simplification of the Internal Revenue Code.

Maybe we know enough about simplification to try some experiments. The Joint Committee's Report, *Issues in Simplification of the Income Tax Laws* reviews much of our basic knowledge. I would like to see the further application of the "reverse legislation" theory to additional problems. Jim Eustice's "split-tier" notion has a pragmatic reality for the Schenk and O'Byrne worlds. I cannot fault Stan Surrey's call for continued research; I would like to see that research directed to simplification for farm business taxpayers. I applaud the New York State Bar Association Committee because its report gives off an odor of interest in the peasantry of taxation.

And, if you will forgive the immodesty of a participant, this Conference has added something to our understanding of the problems of simplification. More important, it has raised the consciousness of the participants to the goal of simplification. Perhaps this record of the proceedings will help to raise the consciousness of many others who are concerned about the complexity of our tax system.

Simplicity as a tax goal has been the orphan. Tax policy has been directed to promoting the economy, preventing the cheats from making a buck, protecting the environment, redistributing the income, providing now and again for an aggrieved group, and a score of other purposes. There has been no lobby for simplification. Simplification as a

tax policy goal always receives lip service, but other goals have pushed it into the background so that it receives the lowest priority.

Every Secretary of the Treasury within my knowledge has warned us of the coming taxpayer revolt. Professor Schenk warns us again. I don't really believe that taxpayers will violently revolt. But we should understand that a tax system must be adapted to the taxpayers upon whose backs it is carried. Sound tax policy must be directed toward maintaining the miracle of the self-assessment system. It does work, and we must be concerned about keeping it working.

My point is simply this: Let us now give the highest priority to simplification. In the past, we have let our notions of important tax policies sacrifice simplicity as an important goal. Maybe our consciousness is now raised. Maybe we believe that simplicity is a worthwhile and important goal.

To achieve simplicity, even more is demanded. To say that it is a "worthwhile and important goal" is not enough; lip service is too easy. We are going to have to decide how to ask the policy questions. We should not ask, "How do we get the manipulators of the system?" Rather, the question must be "How do we make it easy for taxpayers to voluntarily pay their share of the cost of civilization?"

The Commissioner is philosophically sound when he suggests that the Service has a duty not to create a burden on taxpayers filing returns and that the Service should strive to make compliance attractive. Compliance will be more attractive as it is made easier.

CONCLUSION

Simplification must proceed on many levels. I suggest one of those levels in the context of one group of taxpayers, the commercial farmers. We might set up a task force to:

(1) Review related statutory provisions to see if differences are necessary

(2) Examine statutory provisions that seem to be overly complex to see if the complexity is necessary

(3) Seek the assistance of the Service on simplification through:

(a) Relaxation of procedural rules

(b) Establishment of toleration guidelines

(c) Prompt publication of Service positions to give taxpayers and practitioners early guidance on proper compliance.

It will be a long, tough, dirty, and tedious job. But we might as well get started in the least controversial areas and see if we can achieve some progress toward simplification. We can find out whether we are naive reformers dreaming of a tax Shangri-la or hard-nosed realists who can make our tax system effective and workable for most of the taxpayers of reasonable goodwill.

Putting together these comments has been great fun. But I cannot escape the feeling that the elephant has labored and brought forth a mouse. A point of termination must come to this rehash of my fantasies. So I save the notes that would not work into this piece and the notions of simplification that I do not yet have under control for some other time.

I leave you with Bert Lance's great remark, "If it works, don't fix it." But let us get a better understanding of what is not working and try to fix it.

POST-CONCLUSION

After completion of this revision, I found a commentary on simplification that may have lessons for us. The Business Report of the *Wall Street Journal* of March 2, 1978, indicated that professional tax return preparers were delighted with the "government's attempt to make it easier for individuals to figure their own taxes" by simplifying the forms because it increased the return preparer's business.

I find two lessons: First, that what we regard as simplification may not be, and second, that the professional return preparer will be even more important to compliance in the future.

Onward and upward to simplification.

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Two Aspects of Tax Complexity: The IRS and What It Can Do; The Quest for Simplicity Cannot Become a Drive for Further Tax Breaks

Meade Emory

Two things seem clear about the quest for tax simplicity. First, although the Internal Revenue Service is valiantly struggling to make compliance by millions of taxpayers less complex, it is severely limited by what it can accomplish in this area. Few would dispute that the principal problems fostering complexity originate in the Internal Revenue Code. This places the main burden for achieving simplification on the Treasury Department and on Congress, primarily the latter.[1] Despite the fact that the Service is thus limited, there are certain things it can do (most of which it has already started or has attempted to start to do).

A second important point to make is that the quest for tax simplification cannot be allowed to become a Trojan horse for further tax breaks. Most of us can conceive of ways in which present tax complexities, mostly of the tax expenditure variety, can, with a swift cut of the sword of simplicity, be made really quite simple. It is, for example, alleged that depreciation is now too complex because of the abundance of methods and useful lives and the mysteries of ADR. The ultimate simplification becomes, then, the immediate expensing of capital goods and equipment. Before all rally around this flag, care should be exer-

* Meade Emory is a member of LeSourd, Patten, Fleming, Hartung & Emory, Seattle, Washington, and was a Visiting Professor of Law at the Southern Methodist University School of Law in Dallas, Texas.

1 "Congress, of course, being the fountainhead of legislation is perforce the major 'villain' in the complexity scenario. They started it all; they wrote it." Eustice, *Tax Complexity and the Tax Practitioner,* 8 TAX ADVISOR 27, 30 (1977).

cised to ensure that this is really not "throwing the baby out with the bath water" and that it is not possible to achieve a less complex operation of the depreciation rules without sacrificing principles that lie at the heart of the rationale of an income tax. The second part of this paper will attempt to examine the suggestions made for business tax simplification against this standard.

THE IRS AND TAX SIMPLIFICATION

The Effect of Regular and Massive Legislative Changes

The myth of Sisyphus comes graphically to mind when one pauses to contemplate the enormous burdens placed upon tax administration by the flood of legislation. Regular legislative change that is tardily enacted, replete with amendments applying to the current year (and even to past years), and often adopted with nary a thought of the tax administrator's present or future problems, imposes a burden on the Service of nearly unmanageable proportions. It has been suggested that one clear path to tax simplification would be the imposition of, for example, a five-year moratorium on tax law changes. This would allow both the practitioner and the taxpayer to grasp the subtleties of the law and to become acquainted with the provisions that affect them. As long as the tax law is used to accomplish almost everything in our economy, however, and as long as there is such a preoccupation with fine tuning (or "tinkering," as it is called) the statutory maze, it is probably naive to think there will be any reduction in the flow of tax law changes. Nevertheless, perhaps the manner in which the tax code is changed can make it easier for the Service to meet its responsibilities.

The Service Must Have a Greater Role in the Tax Legislative Process. A recently revised policy statement of the IRS states that although the chief responsibility for tax policy matters is with the Treasury Department, the Service can comment on "the effect on the Service or on tax administration of certain existing or proposed provisions." [2] There has been, through the years, a tendency on the part of Congress and the Congressional staff to construct a complex legislative solution and to tend to assume that the Service "will be able to figure out" a way to solve the new statute's obvious administrative problems. Time and time again the Service has risen to the task, but not without straining its resources and certainly not without adding

[2] P-1-24, approved Aug. 12, 1976.

layers of complexity to the statute that could have been avoided if the Service had been closer to the legislative firing line.

As complex as the Tax Reform Act of 1976 turned out to be, all who were close to the statute's enactment know that the situation would have been far worse for tax administration if former Commissioner Donald C. Alexander and his staff had not been as active in providing the Hill staffs, and the Committees during mark-up, with relevant insight into the effect of the various approaches being considered on tax administration. Title XII of the Tax Reform Act of 1976, for example, containing the most far-reaching amendments to the administrative provision of the Code in a generation, was enacted with regular input from the Service (right up until the final decisions were made by the conferees). Although the final product was not entirely to the Service's liking, the administrability of the new provisions appears to be proceeding smoothly, due, no doubt, to the fact that the agency charged with implementation was present at the time of Congressional decision-making.

The Treasury Department has, of course, regularly consulted with the Service in advance on the effect of various proposals on tax administration. The difficulty is that often, in the actual enactment process, the Service is not permitted to provide its reaction to administrative problems it would face or to suggest another, perhaps equally appropriate but less complex, way of accomplishing the same objective. There are signs that this is changing, perhaps fostered by the beneficial experience associated with the 1976 Act. Nowhere is the need for advance reaction by the Service more important than in the area of tax forms. These are the documents that to most taxpayers are the basic source of complexity. If the proposal is not capable of being reduced to a comprehensible form, this fact alone should be grounds for performing surgery on the recommendation. It is now, however, standard procedure of the Service forms people to work closely with the Office of the Assistant Secretary (Tax Policy) in planning to see what a proposal "would look like" as a form. The difficulty comes, of course, when Congress begins its own deliberations with respect to the proposal. At that point, the events simply break too fast to permit the luxury of simultaneous forms development. In certain situations, however, it might be possible to submit to the tax-writing committees exemplars of a form reflecting a proposal the committee is considering. This would be especially important when changes to provisions of widespread application were being considered, such as those involving child care and moving expenses. In such a situation, seeing a form reflecting consider-

able complexity might constitute a "brake" on the committee's action and cause it to consider another, less complex, approach.

In sum, the Commissioner of Internal Revenue can become more than simply a publicist for the problems created for the tax system by inordinate complexity. It was no doubt beneficial for former Commissioner Alexander to inform taxpayers, in his message accompanying the 1976 Form 1040 package, that the form was "more complicated" and to point out that simplification was primarily the responsibility of Congress. But this kind of educational effort is not enough; as the buck of day-to-day administration stops with the Service, it should be "present at the creation."[3] This is not to suggest, however, that the leadership role of the Treasury in tax policy matters be in any way diminished. Tax policy is in their domain, and it should not be invaded by the Service.

The Disaster of Legislative Timetables. Tax laws always seem to be enacted near the end of the year. Maybe this is inherent in the legislative process. The Tax Reform Act of 1969 was enacted on December 30, 1969, but this was not too bad for tax administration because almost every one of its provisions was not effective until 1970 at the earliest. Of late, however, Congress seems to be acting with increasing lack of concern regarding the minimum timetable that the Service must follow if it is to administer the system in any kind of rational way. The final decisions regarding the Tax Reform Act of 1976 (which contained many provisions effective during that year), were made so late that those in the Service responsible for the development and distribution of forms and instructions seriously talked of the possibility of printing the 1976 Form 1040 in the newspaper and distributing it in that fashion. Once again, however, the Service, through the most massive effort possible (picture, if you will, Commissioner Alexander sitting in the committee room working on the galleys of the forms as the decisions are being made), rose to the occasion, with the result that forms were distributed only a few days later than usual.[4]

Matters are not getting better. In developing the 1977 Form 1040, the Service had to play a game of "chicken" because of the tax provisions of the then pending energy legislation before Congress. As the

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[3] Greater and more sophisticated use by the tax-writing committees of the Service's Taxpayer Compliance Measurement Program (TCMP) data, which shows the source and nature of taxpayer errors, would, for example, seem to be a fertile area of development.

[4] A disadvantage of success in this kind of effort is that it fosters the impression in Congress that the Service can respond, in a reasonable manner, to almost any timetable that the Congress necessitates. This is simply not so; in 1976 the Service was, indeed, pushed to the limit.

final "print date" arrived and the future of the energy legislation was still uncertain, the Service had to print the Form 1040 with two blank lines for the various energy credits (home insulation, solar, and so forth) that the bill contained (one line if the credits were enacted as nonrefundable credits, the other line if they were made refundable). Certainly, the off-form calculations made necessary by such approval were more prone to error. The Form 1040 is mysterious enough without adding the vagaries of blank lines about which the Service "will tell you more later" if Congress enacts the pending bill.

Also sensible tax administration was by no means given a boost when the many uncertainties contained in the Tax Reform Act of 1976 were not resolved by the enactment of the Technical Corrections Act of 1977. When the "print date" came, the Service made an educated judgment that technical corrections would be enacted during 1977 (all signs indicated this to be so) and printed its forms and instructions on that basis. The year ended, however, with the bill bottled up in the Senate Finance Committee. This left many 1976 Act uncertainties unresolved and the Service had to prepare errata sheets and notices regarding some of its forms and instructions.[5]

The blame for the problems thus created cannot all be laid at the doorstep of Congress. The tax bar and the other professionals and professional groups who sell their positions to the Congress often act without regard to the welfare of the tax system. Certainly, the tax bar must take a major share of the responsibility for the present complexity of the tax law.[6] They cannot also be held blameless for the strain that tardily enacted and retroactive legislation places upon the Service. Somehow, to borrow the wording of the report on tax complexity of the Tax Section of the New York State's Bar Association, the bar has to develop an "appetite," that is, a "concern with the integrity of the tax system." [7]

What the Service Is Doing, Perhaps It Can Do More

IRS Forms and Publications. It is not through the Code but through the Service's forms and publications that almost all taxpayers get their taste of the complexity of the tax law. For a number of years, the Service

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[5] *See generally* Emory, *Technical Corrections and Carryover Basis: Is the American Bar Association Section of Taxation Acting in the Public Interest?*, TAX NOTES 27 (Jan. 9, 1978).

[6] *See* Eustice, *supra* note 1, at 32.

[7] Roberts, Friedman, Ginsburg, Louthan, Lubick, Young & Zeitlin, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 327, 374 (1972).

has attempted to simplify the content of its forms and to reduce their number. This has been coupled with a fierce determination, exhibited by former Commissioner Alexander and continuing today, to resist outside efforts to require nontax data on tax forms. The Service has conducted a line-by-line review of the major return forms in an attempt to delete unnecessary items and to improve their understandability.[8] (The IRS recently estimated that, as a result of these efforts, its demands on the time of taxpayers are down by 10 per cent). These efforts by no means indicate that there is not more to be done. There certainly is. The key point is that the Service is more aware of the complexity problem than ever before, and it is doing more than it ever has, within its admitted limitations, to meet the problem.

One thing that is not entirely clear is the extent to which there is real concern among the tax-paying public regarding the complexity of the forms and instructions and exactly where, and in what form, this unmanageable complexity is thought to exist. (The high percentage of individual returns prepared for taxpayers by income tax preparers does not, certainly, tell the Service all it needs to know.) Recently the Service has embarked on three courses of action that could give it considerably more information regarding what problems deriving from complexity exist. First, the Service is sending a Tax Form Questionnaire to 40,000 randomly selected taxpayers that seeks to elicit from the respondents briefly stated information about taxpayers' specific problems with the tax forms. Second, during 1977 the Service held public hearings in three major cities (Boston, Oklahoma City, and Portland, Oregon), to obtain more information from rank-and-file taxpayers concerning the complexity associated with their filing obligation. Third, also during 1977, prior to mass printing the final version of the individual income tax return, the Service tested it (using hypothetical facts) on several fairly large groups of taxpayers. All these steps were designed to give more reliable information about the types of complexities taxpayers have been encountering in meeting their filing obligations and help the Service to take more intelligent and responsive actions to meet taxpayer needs.

One essential fact regarding form simplification must, however, be kept in mind. Certain information is required to be included in the return both for the benefit of the Service in processing the return and for the taxpayer in determining his tax liability. We can all suggest ways in which less information could be required on a tax return form,

[8] This same kind of effort has been expended with respect to the instructions, including a special effort to put them (especially those accompanying the Form 1040A) in understandable and clear language.

thereby hopefully making it less complex, but we would also be forced to ask whether the requested information would not be something the taxpayer had determined in any event and whether the data requested would really be quite essential to the rational operation of the tax system.

It has been suggested, for example, that sole proprietors filing a Schedule C with the Form 1040 have a definite advantage over partnership filers, since the latter have to include a balance sheet with their return. Although the compilation of this additional data does represent an additional step for partnerships, the data are, in most instances, readily available (or determinable). In any event, given the quasi-entity status that a partnership is accorded under the tax law, the data are probably essential for making relevant tax determinations. Certainly, if there are inventories or the partnership uses the accrual method, a balance sheet would appear necessary. Perhaps when the cash method is used, partnerships could be permitted to dispense with the balance sheet. Another example is Form 4832, which requires abundant data from users of ADR. It would appear that this form, which requires depreciation data that is not required of those who do not use ADR, is not necessary and could be eliminated, especially in view of the fact that data obtained from the form is used primarily, and perhaps only, for statistical purposes.

It is also suggested that the Service more precisely tailor its forms to the needs of a particular business in order to avoid the necessity of having taxpayers wade through a tax form, portions of which may not be relevant to them. A threshold observation concerning this suggestion is whether the proliferation of choice in the type of form used would not, by itself, add a layer of complexity. In any event, the Service should and has given consideration to modeling forms and filing requirements more specifically to the needs and obligations of particular taxpayers. One example of such an effort, and a particularly successful one, is the development of the Form 5500-C, a two-page form designed to reduce the pension plan burden for plans with less than 100 employees.

IRS Efforts for Small Business. There are a number of areas in which the Service is steadfastly attempting to improve the lot of the business taxpayer, especially the small business taxpayer.

As part of its educational function, the Service has an obligation to make small business taxpayers aware of their obligation under the tax system in a manner that is as comprehensible and as nonintimidating

as possible. In this regard, the Service has sponsored, in conjunction with the Small Business Administration, a number of small business workshops (over 920 in 1977, representing an increase of more than one third since 1976). A four-pocket folder (*Your Business Tax Kit*), designed to hold forms, instructions, and other information regarding business tax filing, is sent to the more than 250,000 businesses requesting new employer identification numbers each year. A principal feature of this program is that an IRS employee will personally arrange with the taxpayer to receive the kit from the Service in order to establish a contact point for the taxpayer in case he needs any further help. In addition, the Service's publications for small business and for farming have been enormously well received and are really, in a sense, "bibles" for those taxpayers using them.[9]

During 1977, the Commissioner's well-run Small Business Advisory Group was terminated and its functions transferred to a Treasury-wide advisory group dealing with small business. This change, which was made the sole reason for reducing the number of advisory groups across the executive branch, may not prove to be in the interests of small business. Prior to the change, representatives of small business had, through quarterly meetings with Service personnel, direct input into Service thinking regarding their problems. Moving the group up to the departmental level will remove it from direct contact with the Service and may, perhaps, diminish the significance of its deliberations insofar as Service policymaking is concerned.

Tolerances. Frequently a call is made for the establishment of tolerance levels, more safe harbors, which would, it is alleged, simplify the task of self-assessment.[10] This issue must, however, be examined closely. Does the announcement by the Service of audit (or other) tolerances really simplify, or does it constitute an invitation to taxpayers to play "fast and loose" with the tax system? Perhaps former Commissioner Alexander put it best when he indicated that the revelation of such data, if indeed it exists, could constitute a "roadmap to tax evasion." If this is so, it would obviously be too great a strain to place upon the system, no matter how much simplification it might bring. Even if taxpayers did not overtly claim nonincurred expenses up to the tolerance level, there can be little doubt that taxpayers (knowing of the tolerance level) would resolve doubts about the deductibility of items in their

[9] This is especially so of the widely used Farmer's Tax Guide (Pub. No. 225), perhaps so widely used because it puts in a single place principles of general application to a single industry. "The explanatory pamphlets are excellent." *See* O'Byrne, *Simplification for Agricultural Taxpayers*, *supra* at 237-49.

[10] *E.g.*, O'Byrne, *supra* note 9, at 250-54.

favor. Most likely, they would not go that far if the tolerance level were not known. The bottom line is this: If a taxpayer's rights or duties are affected, then he certainly has a right to know Service policy. One looks in vain, however, for how an administrative tolerance affects taxpayers' rights. Taxpayers are simply required to do what the law requires of them, claim what deductions the law allows, and so forth; and the announcement of internal tolerances will not assist them in that regard.

Elections. Elections are certainly the antithesis of simplification. Despite the fact that Professor Lyon issued an eloquent call more than a decade ago [11] for a reduction in the harmful effect of failing to make a timely election (or in making the wrong election), little, if anything, has been done to enlarge taxpayers' options in this regard. The tax law is replete, of course, with situations in which (by statute or regulation) an election is irrevocable or must be made within a specific time span. If no harm befalls rational tax administration (other than the cry that administration would be more "orderly" if timeliness or irrevocability were the rule), the Service should, with dispatch, do what it can administratively and seek legislative change in those areas where it cannot act alone. Professor Lyon suggests that the Service has authority (under Section 6081) to grant extensions for the making of elections, even when the time period is provided for by the Code, and that a broader declaration of policy regarding elections could be made under the little-used Treasury Regulation Section 1.9100-1.

Any such action by the Service, however, should have a steady eye cocked to the needs of tax administration. The current situation involving elections under Section 453 (installment sales) is a case in point. After the court decisions permitting taxpayers to elect the installment method on an amended return,[12] a compliance problem developed for the Service. Under current practice, a taxpayer can "elect" the basis recovery method (*Burnet v. Logan*) by not reporting the sale on the return for the year of sale. If, upon audit, this method is disallowed, the taxpayer may adopt the installment method. The Service is concerned that some taxpayers "electing" capital recovery may be playing audit roulette and may not be reporting the proceeds of the sale after basis is recovered. Perhaps the regulations can be modified to treat the basis recovery method as one that is "inconsistent" with the installment method. Somehow, an approach must be developed to segregate those

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[11] Lyon, *Tax Blunders: Treasury Should Reduce Their Cost,* 45 Taxes 575 (1967).

[12] *See* Emory, *The Installment Method of Reporting Income: Its Election, Use, and Effect,* 53 Cornell L. Rev. 181, 220-29 (1968).

taxpayers who in good faith choose capital recovery from those who simply use that method as a means of keeping the sale secret. Perhaps if the year or years subsequent to the sale showed a reporting of the proceeds in excess of basis, a switch to the installment method would be allowed; if they did not, then later election of the installment method would not be permitted. In any event, this situation demonstrates that requirements of timeliness can be essential to effective tax administration and that the adoption of an across-the-board rule permitting taxpayers to make an election at any time when the year is "open" will not work.

Getting the "Word" Out. Almost all of those commenting upon the complexity of the tax law indicate that one of the prime sources of complexity is the uncertainty regarding the law or the Service's position on it. No doubt, matters are better on this score than they once were. In the area of private letter rulings, both the adoption of the 15-day rule [13] (designed to give the requesting taxpayer a quicker response) and the recent legislation (Section 6110) making private letter rulings public should have a salutory effect.

Beneficial changes seem to have been made in regard to the promulgation of regulations, an area in which there have been regular cries for more responsiveness to the needs of taxpayers.[14] To get the Service position out quickly on a number of important issues arising from the Tax Reform Act of 1976, temporary regulations were used. Although these pronouncements are made without the benefit of a hearing and often tend to be more "permanent" than "temporary," they do result in expeditious notice to taxpayers in areas where they simply want to know "what to do" or how to plan their transaction. Further, the regular issuance by the Legislative and Regulations Division of the Chief Counsel's Office of a list of pending regulation projects (and the Service and Treasury attorneys assigned to the projects) opens up the status of the project and allows the Service to receive, in a more direct manner, recommendations regarding the relative priority that should be accorded to various pending projects. The Chief Counsel's Office has also instituted procedures designed to speed up the review process, as well as to pare down the scope of the regulations, by not including material that is clear from the statute and that is in no need of further amplification.[15] There can be little doubt that delay will be an integral part of the

[13] Rev. Proc. 76-29, 1976-2 C.B. 646.

[14] *E.g.*, Roberts, *Overview: The Viewpoint of the Tax Lawyer*, *supra* at 1, 17.

[15] *See generally* remarks by Stuart E. Seigel, Chief Counsel of IRS, to the 1977 Indiana Tax Institute (Dec. 2, 1977).

regulation process as long as the Service is faced with the torrent of regular legislative change that has been its diet for the past several years.

The time that the Service takes to respond to new tax-saving devices has also been a fertile area of discussion. There appears to be no doubt that the people within the Service realize that they have a greater responsibility to act quickly and more effectively than they have in the past. Much of the problem, of course, relates to information gathering. What is the best way for the Service to obtain data on the types and nature of transactions in which taxpayers are engaging so that they may, indeed, respond? Generally speaking, the use of audit as an information-gathering technique is not adequate because of its tardiness. If early detection is to exist, the responsibility is best established within the technical office of the IRS. To this end, the Service has established a National Office Tax Shelter Committee, which has the responsibility for collecting input at an early stage from field offices and other sources regarding proposed and pending tax shelter investments.[16] When the Service has to suspend an issue in the national office, it results in unwelcome uncertainty in the handling of tax issues. When this suspension results from Congressional action, as it will when Congress tells the Service not to promulgate rules in the fringe benefit area, the damage to the tax system seems even more unfortunate.

Another fertile source of this kind of information could be the tax bar itself. Many tax practitioners assume the responsibility of telling their clients that tax gimmicks will not or probably will not work. Because less skilled and less ethical practitioners would be happy to recommend questionable transactions to their clients, it would seem that responsible practitioners would be interested in seeing the Service react quickly and could, therefore, be expected to report relevant information to the Service.

THE QUEST FOR SIMPLICITY CANNOT BECOME A DRIVE FOR FURTHER TAX BREAKS

It has been said many times that one of the main, if not the main, sources of complexity in the tax law is the presence of the myriad forms

[16] An essential question is the extent to which the Service can act on media articles or information it obtains at tax conferences without a "real" case. Where a tax-savings device is simple, such as the year-end, tax-motivated divorce followed by remarriage the next year, a real case does not seem to be necessary. But tax shelters, for example, are very complex (and these complexities constitute the basis for the hoped-for tax savings). Thus a "real" taxpayer involved in an actual transaction is probably essential before the Service can announce its position.

of tax expenditure items.[17] Although tax expenditure provisions are readily recognized as sources of complexity, it seems that talk rarely centers around doing away with the tax expenditure as a means of obtaining simplicity. Rather, it takes one of two forms. Since many tax expenditure items are used in a manner that was not intended, legislative change often takes the form of efforts to correct its abuse by narrowing its application, with the result that another layer of complexity is added. Or, the quest for simplicity can take another form by simply removing from the provision the reasonable limitations upon its use. This simplifies the provision but also increases the breadth of the tax benefit.

In searching for tax simplification, special care must be exercised to ensure that those asking for simplification are doing so responsibly and that the alleged complexity is not either tolerable[18] or one that is not really a complexity at all. For example, recent Tax Compliance Measurement Program (TCMP) data of the Service regarding errors on farmers' returns shows that the leading error item was failure to adequately report gross income. This error rate (16 per cent) cannot really be attributable to avoidable complexity, since calculation of income is a necessary feature of even the most simple income tax. Nor can inventories be thought to be unduly complex for farmers, since that area generated only a 16 per cent TCMP audit change rate.

Depreciation

In the area of depreciation, the clarion call, based on the simplicity it would foster, is for the immediate expensing of capital goods and equipment.[19]

Nowhere is the superb irony of the present situation in the complexity-simplicity area more obvious than in the area of tax write-offs for capital goods and equipment. Agitation for faster recovery of

[17] *E.g.*, Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROB. 671, 683 *et seq.* (1969).

[18] The point is made, for example, that although the minimum distribution rules of Subpart F were complex, they were mastered by the few (200 or so) in the country that had to work with them. Thus although intricate, "the regulations achieved a high degree of predictability." Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861, 862 (1976). Large portions of Subchapter C do, however, affect small business and are fraught with considerable complexity. For example, note the disastrous result that the failure to properly utilize either Section 333 or 337 or to effect a sale of stock rather than assets can have on the tax consequences of an installment sale of a small business. 118 CONG. REC. 35,644 (Oct. 12, 1972) (remarks of Rep. John W. Byrnes).

[19] *See* Krane, *Depreciation, Investment Tax Credit, Capitalized Versus Deductible Expenditures and Prepaid Expenses*, *supra* at 263.

capital goods and equipment prompted the Service to depart (in 1946) from its prior practice of requiring recovery pursuant to the straight-line method. The permissive use of 150 per cent declining balance in 1946 blossomed, in 1954, into Code amendments authorizing several accelerated methods. Likewise, agitation regarding useful lives prompted, in 1962, the adoption of guideline lives shorter than the prior Bulletin F lives—although this change certainly contained more than a scintilla of simplification—and, in 1971, the adoption of even shorter lives pursuant to ADR.[20]

Admittedly, the choices involved in the selection of depreciation methods and the complications inherent in the ADR system can be burdensome. But it strikes one as more than just slightly ironic that it should now be urged that this state of affairs (built at taxpayers' urging and lovingly embraced by them)[21] be junked in favor of what is regarded as the ultimate simplification—immediate expensing of equipment for tax purposes. If this wish is granted, one wonders what will be left to concede to taxpayers in this area, which is really only the current write-off of subsequent replacement costs.

Depreciation—How Complex? The basic concept of depreciation, recovering the cost of an asset over its useful life, makes it a feature of the law that Professor McDaniel would call "structural" because it is necessary to the implementation of the income tax.[22] It is only when accelerated depreciation enters the picture and engineering lives are ignored that depreciation acquires the character of a tax expenditure and becomes the hybrid that it is. When a plea, based on extreme complexity, is made for junking a provision of the tax law that is a fundamental part of the concept of that tax, the parties urging change must make an exceptionally strong case. This is especially so when the change urged would bestow a significant tax bonanza at a high revenue cost.

Some, seizing upon the admitted complexity of ADR as presently

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[20] *See generally* Emory, *The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues,* 29 TAX L. REV. 1, 47-53 (1973).

[21] Note that tax reductions are not spurned or even viewed askance when enmeshed in a complex set of rules (*e.g.,* the investment tax credit). Professor McDaniel says it best:

> It can be said without fear of contradiction that no beneficiary of a tax expenditure will call off its lobbyists just because it is advised that their efforts are making the tax system more complicated. No such beneficiary will quietly acquiesce in the repeal of its tax subsidy just because the Treasury seeks a simpler tax system.

McDaniel, *Federal Income Tax Simplification: The Political Process, infra* at 447, 519.

[22] *Id.* at 450. With respect to structural aspects, as distinct from tax expenditures, Professor McDaniel suggests "elimination of complexity is not a goal, but achieving rational coherence is."

administered, suggest that the entire concept of depreciation is inconsistent with the achievement of simplification.[23] And yet this is no more than a conclusion. No data is offered regarding the difficulty that taxpayers, even small taxpayers, have in applying the fundamental principles of depreciation (divorced from ADR). If there is a complication, it is no doubt related to the existence of choices that the Code provides. Obviously, straight-line depreciation is the simplest to employ, and when it is the only method (as it was prior to 1946), depreciation is complexity free. In this era of tax expenditures, it would be naive to assume that a return to those days is possible; but, for example, a reduction in the number of depreciation methods available for Section 1245 property, in addition to straight-line and double-declining balance methods, would be a short step toward simplicity.[24] Removal of salvage value considerations, which are not nearly as important when the depreciation taken is recaptured as ordinary income, would be another short step toward simplification.

At bottom, however, the concept of depreciation, with all of its features (including depreciation recapture), cannot be considered a real source of complexity.[25] (The only way to really avoid the perceived complexity of depreciation recapture is to limit depreciation to actual decline in value.) There are, though, some complicating aspects of depreciation as it presently exists which perhaps should be removed in the interests of simplification. Additional first-year depreciation comes readily to mind. Admittedly, immediate expensing of capital goods and equipment might be simpler, but it would be at the cost of sacrificing the fundamental principle of "clear reflection of income" (that matching of costs and income that lies at the heart of a rational income tax).

Aside from the urged simplicity, those calling for change have the temerity to offer, as a reason for immediate expensing, the stimulative effect such a change would have. No doubt that would be the case, but

[23] Krane, *supra* note 19, at 272. *See also* Bierman, *A Case for Immediate Expensing for Tax Purposes,* 144 J. Accountancy 87 (Oct. 1977).

[24] Perhaps sum-of-the-years digits would be the appropriate accelerated method to retain, since it generally yields more in aggregate depreciation deductions during the first half of an asset's life than double-declining balance. The fact that declining balance yields an unusually high salvage value and that conversion to straight line is permitted during the asset's later life (I.R.C. § 167(e)) might be a reason to opt for sum-of-the-years digits on grounds of simplicity, as the sole accelerated method.

[25] *Cf.* "The depreciation rules are extraordinarily complicated." Ginsburg, *Simplification for Individual Taxpayers, supra* at 41, 68. Here the reference is primarily to the various methods that exist for real estate (I.R.C. § 167(j)). The existence of choices or niches into which various real property is to be put is clearly a source of complexity that would be cured by limiting all real estate to straight line, as suggested in the Department of the Treasury, Tax Reform Option Paper IV. *See also* The President's 1978 Tax Program, Detailed Description and Supporting Analysis of the Proposals 321-24 (1978).

at an enormously significant revenue cost (which, curiously, the proponents of immediate expensing seem to either ignore or gloss over).[26] In any event, it seems inappropriate to suggest at a conference on simplifying the income tax that an existing tax expenditure be made even larger (much larger) because taxpayers "making investments would incur fewer taxes than firms not investing. . . ." [27]

Would Immediate Expensing Be That Promotive of Simplicity and Equity? The proponents of immediate expensing assume that it would completely rid the Code of the entire depreciation concept. This may not be so. First, is it entirely clear that all taxpayers would want the immediate deduction? The fact that some taxpayers would want to write their assets off over a longer period of time (for example, Penn Central in its later days was using the longest lives possible for its assets) would dictate the maintenance of the depreciation system (and create the existence of a choice that, alone, can be a source of complexity). Second, what would be the effect on the minimum tax base? If it makes sense to include five-year amortization in the minimum tax base, it would seem to follow that deductions attributable to immediate expensing also be included (thereby significantly widening the scope of the minimum tax). Further, even if taxpayers did immediately expense investments, would not many be required to employ a depreciation method for purposes of financial statements?

Considerable problems would seem to be created insofar as the equity of the tax system is concerned. For example, the tax shelter potential of immediate expensing would be enormous. Any rule that creates the sizable deductions that would be produced by immediate expensing would be seized upon by peddlers of shelter arrangements to an extent probably hitherto unknown. (This would probably be so even if at-risk

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[26] Krane enigmatically states "[W]hile the government may initially lose revenue based on such a proposal on longer-lived assets, the costs saved in administering the present complex rules may offset any loss of revenue." Krane, *supra* note 19, at 272. Another writer glosses over the revenue cost by discounting the present value to the fisc of the taxes lost to the government as a result of accelerated depreciation. Bierman, *A Case for Immediate Expensing of Equipment for Tax Purposes*, 144 J. ACCOUNTANCY 87, 88 (Oct. 1977). (Government revenue estimates are traditionally done on a cash flow basis for the year in question.) If one compares the cost of immediate expensing, on the one hand, and accelerated depreciation (DDB, 10-year life) and a 10 per cent investment credit, on the other hand, of $100 billion in capital goods (which is conservative, since the 1977 figure is about $125 billion), using a 10 per cent annual growth factor, the first-year differential would be about $30 billion. Although this revenue cost would decline (to about $25 billion in the second year, $21 billion in the third, $18 billion in the fourth) and eventually disappear following the investment in one cycle of assets, the front-end revenue costs of such a proposal are staggering and make that aspect a threshold, rather than a tag-end, consideration.

[27] Krane, *supra* note 19, at 272.

rules applied to such investments. It is doubtful, however, that many business taxpayers would find immediate expensing that is subject to an at-risk principle very inviting, since present depreciation policy permits recovery of the cost of an item even though acquired on credit.) Attempts to curb the tax shelter effects of immediate expensing would result in what Professor McDaniel refers to as the second layer of complexity—those provisions added "to limit the adverse effects of the special tax provisions on the tax equity."[28] Further, one can wonder about the effect on the equity of the tax system of an approach that would allow a taxpayer earning a $30,000 profit from his business to avoid tax liability by making a tax-motivated purchase of equipment (perhaps with borrowed amounts) that he intended to use over the next five years.

Simplification of ADR.[29] There is little doubt that the almost minimal use of ADR by small businesses is distressing. (Recent data indicates that although 63 per cent of businesses with assets of $1 billion or more used ADR, only .9 per cent of the businesses with assets under $500,000 used the system.) Rather than toss out the fundamental concept of depreciation because of the minimal use of ADR, however, every effort should be expended to render the system more available to small business. It would appear that many of ADR's problems are more imagined than real. Consequently, great strides would be taken if the more intimidating aspects of the system were removed. By attempting to cover every conceivable problem in their 95,000 word bulk, these regulations, as a result of their sheer size, are intimidating. Many problems dealt with at length in the regulations (for example, normalization and flow-through) apply to only a small number of taxpayers and should not complicate a regulation intended for wide use. Those who have closely examined the present regulations believe that a streamlined ADR system could be put in regulations having general applicability in less than $^1/_{10}$th of the space they now occupy. Fundamental to such a paring down to essentials would be a reduction in the number of choices and options that presently add to rule upon rule. Some of this, such as a reduction in the number of depreciation methods available, would require legislative change. Most would not. For example, why complicate matters by providing a choice of more than one first-year conven-

[28] McDaniel, *supra* note 21, at 460.

[29] Subsequent to the delivery of this paper, President Carter proposed the adoption of a simplified ADR scheme containing many of the recommendations contained herein (*e.g.*, elimination of special reporting requirements, reduction in the number of depreciation options available, and so forth.) *See* The President's 1978 Tax Program, Detailed Descriptions and Supporting Analysis of the Proposals 321-24 (1978).

tion when one is sufficient? The difficulties that presently surround a determination of salvage value could be removed by a realization that, in the age of depreciation recapture, predetermination of a nondepreciable salvage value is of far less importance to a depreciation system than before. Permitting the taxpayer to begin depreciating the full cost of the equipment (ignoring its residual value) would, admittedly, be somewhat distortive in that more depreciation would be allowed earlier. And yet as long as the taxpayer was not allowed, in any one year, to depreciate the asset below its then fair market value, the fundamentals of a depreciation system would be retained, with a considerable gain in simplicity. The distinction between a deductible repair and a capital improvement still continues to plague taxpayers, even though they use ADR and its class life "repair allowance." The lengthy attempt in the regulations to define "excluded addition," that type of expenditure not eligible for the repair allowance, has had the effect of retaining many of the prior problems. Although it would only be equivalent to rough justice, it could add to the simplicity of the ADR system if taxpayers were allowed to claim as deductible items expenditures up to certain levels each year (determined by asset class), regardless of whether the item was capital in nature (that is, an "excluded addition"). In considering this aspect, however, a distinction must be made between complexity and controversy. Simply because an area results in a volume of disputes with the Service (for example, capitalized versus deductible expenditures) does not mean that "real" complexity exists. In the area of repairs and, indeed, in selecting useful lives for real estate,[30] taxpayers either know or can easily grasp the stakes. The fact that these areas often end up as tax disputes is attributable just as much to taxpayers going for "what they can," pushing their position to its limits, as it is to any inherent complexity.

Perhaps, too, the compliance and reporting obligations of an ADR user could be lessened. Little justification exists for the requirement that taxpayers using ADR report the voluminous data regarding guideline class summaries, depreciation taken, and repairs on the Form 4832. Although this data would seem to be available to every ADR user, the completion of this rather long form requiring detailed data that is not required from non-ADR users would appear to be a disincentive to the use of the system.

30 Due to the failure of the Treasury to weave real estate into the ADR rules, some uncertainty, particularly regarding useful life. is now present as respects real estate depreciation. This problem would be removed if the uniform lives approach to real estate, which has been recommended by the Treasury, is adopted. *See id.* at 81-102.

What Really Constitutes a Simplification, or What Is a Tax Break? Those urging simplification must be dispassionate and not try, in their effort to reduce complexity, to mask what is, in reality, a further tax break as simplification. For example, complexity would not be reduced by providing (as suggested) [31] that goodwill be eligible for depreciation. Taxpayers have known almost since the creation that assets of this character are ineligible for depreciation. To suddenly make them eligible would not "simplify" the tax law but would simply provide a benefit not now provided.

In some instances, an apparent simplification simply substitutes one complexity for another. Admittedly, the ineligibility of buildings and their structural components for the investment credit has been a source of considerable uncertainty and, perhaps, complexity.[32] Would this uncertainty be removed, however, by providing that manufacturing, as distinguished from commercial, structures are eligible for the credit? Certainly, the drafters of the Treasury Department's TAX POLICY OPTION PAPER NO. IX are correct when they note that such a change would "present a new administrative problem."

Inventories

Perhaps the abandonment of the inventory method, as has been suggested (at least for small taxpayers),[33] would bring simplification. Would, however, the cost be too high in both the attendant loss of accounting theory (the matching of revenues and costs) and the loss of equity? Regarding the latter, it can reasonably be asked whether the tax system should countenance a system in which certain businesses, even if they are small, are allowed (as they would be if they were to use cash accounting instead of inventories) to expand their businesses in a tax-free manner.

Prime Costing. Most advocates of simplicity in the area of inventories do not recommend the complete abandonment of the inventory approach, but rather, concentrating on the complexities of the full absorp-

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[31] Krane, *supra* note 19, at 278-79.

[32] Krane, *supra* note 19, at 279.

[33] SENATE SMALL BUSINESS COMMITTEE, MEMORANDUM ON TAX REFORM PROPOSALS, presented to President Carter by Senator Nelson, Oct. 26, 1977. If the Nelson proposal was adopted (cash method for businesses up to a certain level of gross receipts ($1-2 million) complexity would not be reduced for many, since those near the margin would still have to inventory in the event they did not qualify. Further, the "cliff" problem would add to complexity because problems would be encountered by those taxpayers that did not qualify one year, but did the next.

tion inventory regulations,[34] urge the adoption of prime costing (at least for small business).[35] The premise is that in a small business most of the costs are directly related to the making of the product (so-called product costs) and the other costs (so-called period costs) are relatively small. It is urged, therefore, that it is unnecessarily complex to require taxpayers to work through the full absorption regulations when the costs incurred by the small business taxpayer with respect to inventories are really very close to prime costs. All agree, it would appear, that prime costing, the exclusion of all overheads from inventory costs, does not constitute an accepted accounting procedure.[36]

Some form of relief is now available in Treasury Regulation Section 1.471-11(d)(3), which permits the standard cost method. After making a cost study, taxpayers can allocate a specific percentage of their indirect costs to inventory as a form of full absorption. The difficulty here, of course, is that these studies are expensive and time consuming and have to be made periodically if they are to be relied upon. Perhaps, as a simplification, taxpayers could be permitted to use prime costing when they are able to show that their indirect costs are not material (that is, below a specified percentage of their total costs). Although such an approach would be somewhat distortive, it would certainly simplify inventory costing (and at not too great a cost to the integrity of tax accounting principles).

Write-Downs of Excess Goods. Taxpayers using FIFO can cost inventory at the lower of cost or market. It is urged[37] (presumably as a simplification and not as a tax break) that taxpayers be allowed to "write-down" the cost of such inventory simply because demand is less than supply, without satisfying any burden of proof concerning the market value of the inventory. The logical extension of this argument is that in *any* case where market is less than cost, taxpayers have suffered a loss, even though there has not been a realizing or identifiable event. This is precisely why the regulations (Treas. Reg. § 1.471-4) require data on sales for the use of a market value less than cost. The fact that the inventory on hand is in excess of the taxpayer's needs does not justify setting the valuation of the inventory at other than replacement costs. One wonders whether taxpayers would also be willing to accept a "write-up" of closing inventory when the market value of the inventory would be in excess of the cost of such inventory. Thus before the inventory could be disposed of, income would be increased.

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34 Treas. Reg. § 1.471-11.
35 Kubick, *Simplification for Business Taxpayers' Inventories, supra* at 105, 126.
36 *E.g.*, Accounting Research Bull. No. 4, § .05.
37 Kubick, *supra* note 35, at 115.

LIFO Problems. It may be that the LIFO method is fraught with a good deal of complexity for the small business. Certainly, the record-keeping aspects of the method are more burdensome than those of FIFO. One of the aspects of the method most frequently referred to is the conformity requirement (I.R.C. § 472(c)). This requirement was originally put in for two reasons: (1) It was not believed that LIFO accurately reflected income from an accounting standpoint; and (2) the Treasury Department was concerned that the widespread adoption of LIFO would constitute a significant revenue drain and that the existence of the conformity requirement would be a disincentive to the adoption of that method. The method now seems acceptable from an accounting viewpoint, and many taxpayers no longer regard the conformity requirement as a disincentive. Whatever revenue loss was to be felt from the adoption of LIFO has probably already been sustained. All of this leads to the assertion that the conformity requirement is passé. This position assumes that the statement that a taxpayer should not be able to "report riches to shareholders and rags to the tax collector" is essentially a political statement and not relevant to the tax issue.

Admittedly, the Commissioner's use of his discretion under Code Section 472(e) to absolve taxpayers who are caught "between a rock and a hard place" by, for example, a requirement of the SEC that a certain method be used in financial statements has made the use of LIFO less rigorous.[38] Even so, perhaps the time has come to modify the conformity requirement, which, of course, would have to be done by Congress.

LIFO indexing is another area of concern. The regulations clearly authorize adjustment of the cost of goods "to the extent of price changes taking place after the close of the preceding taxable year." [39] Department stores are facilitated in the use of this indexing because the Service, through the auspices of the Bureau of Labor Statistics, has published data on inventory price indexes. Certainly, the existence of this kind of data for drugstores and grocery stores, for example, would render the making of this kind of an adjustment easier. The key question, of course, is who is going to assemble the data. The IRS, already over-burdened in so many ways, simply does not have the resources. Thus it is not really feasible to tell the Service to set up something like Treasury's Office of Industrial Economics, which deals with depreciation lives. Even the establishment of such indices for others would not be

[38] *E.g.*, Rev. Proc. 77-7, 1977-1 C.B. 540. For arguments in favor of conformity generally, *see* Nolan, The Merit in Conformity of Tax to Financial Accounting, 50 Taxes 761 (1972).

[39] Treas. Reg. § 1.471-1(k).

without additional administrative problems for the Service (and complexities for the taxpayers). For example, what constitutes a grocery store? Does a 7-11 store qualify?

ERISA

ERISA is certainly a lengthy and complex statute, as befits one of the most expensive tax expenditure items. ERISA brought a host of new requirements. Most of these requirements, however, were designed to alter deficiencies in the pension system that existed prior to 1974. A statutory and regulatory pattern as ambitious as ERISA will, certainly, take time to get used to. The question is whether, after a sufficient start-up period, it can be said that the efforts expended in modernizing the pension system have been worth the price of adjusting to new regulatory requirements. Just as it is admitted [40] that practitioners were conversant with the pre-ERISA requirements, so, too, they will become familiar with the procedures and obligations of what is hoped will be a sounder pension system under ERISA.

The administration of ERISA by the Service has not been without problems and frustrations for employers seeking to comply with the new statute. The extensions of the filing deadline for plan amendments (to bring the plan into conformity with ERISA) has, unfortunately, had the effect of punishing the diligent. Perhaps this was unavoidable. Other actions taken by the Service and the Department of Labor have been salutory. This is not the place to mention these actions in detail, but they include, for example, the development of single forms to satisfy the annual reporting requirements of the Service and the Department of Labor; the development of one computer system for processing the returns of both agencies; and the making available of a number of drafting aids, such as model plans, standard paragraphs, alert guidelines, and sample plans, which, although useful for all sizes of plans, are especially valuable for small plans. Further assistance is provided through procedures for master and prototype plans and practitioner pattern plans that will facilitate easy adoption and qualification.

Terminations. It is asserted that a significant portion of the plans terminated did so because of the burdens of ERISA.[41] The data for the latest period available, the year ending September 30, 1977, indicates that almost 25 per cent listed the burdens of ERISA as a reason for termina-

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[40] Lindquist, *ERISA—Was All This Really Necessary?*, *supra* at 287, 289-90.
[41] *Id.* at 296-97.

tion. These figures do not, by themselves, indicate too much.[42] Of primary importance is the fact that many of these plan terminations may be consonant with the very purpose of ERISA. If a plan is not really a "rank-and-file" plan that meets the vesting and funding standards prescribed by ERISA, it may, indeed, be viewed as bolstering the overall pension system if it falls by the wayside.

Limitations on Benefits. Presumably, for reasons of complexity, it has been suggested that the dollar limitations on benefits be eliminated.[43] It has also been suggested that these limitations came to the law as a *quid pro quo* for installing IRA's and increasing the H.R. 10 limits.[44] This is clearly not so. The limitation on benefits has an independent policy rationale. Reasons of equity—admittedly the revenue pick-up was slight—prompted placing a dollar limitation on the benefits that could be received. The issue comes down to how the tax expenditure, which is designed to encourage corporate executives to set up retirement plans for rank-and-file employees, is to be allocated. If it is concluded that it only takes X dollars to prompt corporations to do that which is sought, then the expenditure of amounts in excess of that are wasteful. If these excess amounts of revenue are spent in a way that favors one group of taxpayers over another and causes the nonfavored group to question a system that permits such a benefit, the equity of the tax system is seriously threatened. Even now, the portion of the tax expenditure that is involved in pension plans may be seriously misallocated to the highly paid. It is estimated that the tax expenditure for the deferral of pension benefits for a $100,000 corporate executive may be almost three times as high as that for a rank-and-file worker earning $10,000. The mere fact that percentage limitations are "self-adjusting to both inflation and deflation" cannot be said to state a case for change based on complexity grounds.

Prohibited Transactions. Again, presumably based on the ground that ERISA is too complex, it is urged that the pre-ERISA approach be restored.[45] ERISA was designed to bring to the law the type of certainty

[42] Nor can the figures be regarded as reliable. Arguably, the figures may be on the low side because, no doubt, some employers were loathe to list ERISA as a reason for termination. This may have been due, in part, to an erroneous assumption (*see, e.g.*, Lindquist, *supra* note 40, at 296) that the Service would retroactively disqualify plans listing ERISA as a cause for termination. Just as logically, it would appear that many plans were terminated because the employers did not want to make the increased payments to the plans required by ERISA and, therefore, listed ERISA's complexity as the cause for termination rather than state the real reason—employer greed and selfishness.

[43] Lindquist, *supra* note 40, at 304.

[44] *Id.* at 299-300.

[45] *Id.* at 304 .

on this issue that pre-ERISA law, which gauged a prohibited transaction on such subjective grounds as whether the transaction involved reasonable security, lacked. Section 4975 establishes the sought-for certainty regarding what constitutes a prohibited transaction by making the standards objective. It may be thought that it would be worthwhile to assign the entire prohibited transaction area to the Department of Labor to avoid the dual jurisdiction aspects that currently exist. This is not recommended, however, since in transactions between the plan and the employer, for example, there are often tax questions, the primary concern of the Service, in which Labor might only be mildly interested.

Dual Jurisdiction. The regulatory pattern governing the pension area is not simply concerned with pension rights. There are many tax issues arising in the governance of these plans that if assigned to another agency (for example, a new single agency, PREP, as suggested) [46] might very well result in these issues falling by the wayside. This would affect the entire soundness of the pension system. For example, a new single agency would not likely place very high priority on plans with few employees or those designed as tax breaks for owners or highly compensated persons. Today, the IRS controls these plans through the nondiscrimination and benefit rules. If another agency took over nondiscrimination issues, there would probably be less attention to this area. The same might be true with respect to Section 404. The single new agency would presumably have no interest in preventing overfunding. There are many other examples of concerns in which a nontax agency might not have sufficient interest, such as those issues dealing with borrowings or "loans" from the plan and rollover from one plan to another. To transfer the Service's responsibilities elsewhere at this time would waste the considerable start-up time invested by the Service in ERISA administration (including the development of a strong IRS cadre in this area) and cause the process to begin all over again.

This is not to say that the present dual jurisdiction is not without its problems. Perhaps the best way would be, as suggested by Senator Bentsen's bill (S. 901), to provide separate islands of jurisdiction to the two competing agencies, assigning to each those responsibilities that are its primary concern.

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[46] *Id.*

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Benefits and Disadvantages of Federal Collection of State Individual Income Taxes

Daniel G. Smith

INTRODUCTION **

H.R. 11950, a bill for the Intergovernmental Fiscal Coordination Act of 1971, was introduced by Chairman Wilbur D. Mills and nine members of the House Committee on Ways and Means on November 30, 1971. This bill provided for federal fiscal assistance to municipalities and states and also authorized federal collection of state individual income taxes. Following the introduction of this bill, H.F. Freeman, then President of the National Association of Tax Administrators, appointed a committee to analyze those provisions of the bill dealing with federal collection of state income taxes. The committee's initial report and recommendations in respect to H.R. 11950 were issued on April 14, 1972.

In the meantime, following a number of executive sessions, the House Ways and Means Committee ordered a substantial redraft of the original bill. The redraft was introduced as a new bill, H.R. 14370, on April 17, 1972. In addition to changes in the formulas for distributing funds to local governments and the states, some revisions were made in the federal collection provisions (Title II of the bill), several of which stemmed from informal discussions between NATA committee members and the staffs of the Joint Committee on Internal Revenue Taxation and the Internal Revenue Service in the period following the introduction of H.R. 11950.

* Daniel G. Smith is the Director of Taxation of the Wisconsin Department of Revenue, Madison, Wisconsin.

** The material presented includes much of a National Association of Tax Administrators' Committee report, principally written by the author, as its chairman, and updated to include changes in law, a report on states' activities, and observations made of a federal collection system occurring since release of the NATA report in December 1972.

With few changes thereafter, H.R. 14370 passed the House on June 22 and the Senate on September 12, 1972. Following agreement on the conference report, the bill was signed by the President as Public Law Number 92-512 on October 20, 1972.

In 1974 and 1975, the chairman of the House Ways and Means Oversight Subcommittee polled the states' governors to determine their views on federal collection. Only one governor, no longer in office, is reported to have then favored the progam.

Section 2116 of the Tax Reform Act of 1976 (Pub. L. No. 94-455) modified existing law by allowing another optional adjustment to the state tax base subject to federal administration by decreasing prior thresholds for state qualification and by specifying that no charge be imposed on a state for the collection or administration of a qualified state individual income tax. On September 29, 1977, the Department of the Treasury proposed rules for federal collection and administration of qualified state individual income taxes.

A reasonably diligent search of the literature has turned up little evidence of expressed interest in the subject. Beyond the discussions found in the United States Senate and House reports on bills dealing with federal collection and items found in the reported proceedings of the National Association of Tax Administrators, the only close attention given to this matter appeared in 1977 in a university law journal. Stolz & Purdy, *Federal Collection of State Individual Income Taxes,* 1977 DUKE L. J. 59.

In a June 30, 1977, "Revised Draft" of a Commission on Federal Paperwork staff report on the subject of federal taxation, the workings of the federal collection system were explained and previously made arguments for and against the scheme were reviewed. The report concluded that, "since piggybacking has not been adopted by any State and its future prospects appear to be dim, a permanent Federal/State Commission on Tax Coordination should be established to seek alternative opportunities (*e.g.*, standardization of terms) that would provide major relief to a large number of taxpayers."

FEDERAL COLLECTION OUTLINED

A summary of the principal provisions of the federal collection law is presented here. These provisions are found in Section 2116 of Public Law Number 94-455 and in Title II, the Federal-State Tax Collection Act of 1972, Public Law Number 92-512 (H.R. 14370, H.R. REP. No. 1018, 92d Cong., 2d Sess. (Parts 1 and 2) (1972); CONF. REP.,

H.R. REP. No. 1450, 92d Cong., 2d Sess. (1972); S. REP. No. 1050, 92d Cong., 2d Sess. (Parts 1 and 2) (1972) [references hereinafter are to S. REP. No. 1050 (Part I)]).

New Internal Revenue Code Section

Section 202(a) of Public Law Number 92-512 added a Subchapter E to Chapter 64 of the Internal Revenue Code. The "Subchapter E—Collection of State Individual Income Taxes," consists of five I.R.C. sections, Sections 6361-6365. References hereafter are mostly to the added I.R.C. sections. It might be noted that the federal collection system, provided by Subchapter E, differs in several respects from the system proposed in the earlier bill (H.R. 11950, tit. III).

The optional federal collection system and the conditions for participation, as laid down in Title II of Public Law Number 92-512, as modified by Public Law Number 94-455, may be summarized as follows:

Authority To Collect Tax

The bill provides that the Secretary of the Treasury shall collect and administer a qualified state individual income tax for any state entering into an agreement to that effect with the Secretary. I.R.C. § 6361(a).

Conditions To Be Met by the States

(1) The state must file an election to have the secretary collect and administer its individual income tax. *Id.* § 6363(a).

(2) The state must impose a "qualified income tax," that is, the base and the application of the state's individual income tax must meet the standards prescribed in the bill. *Id.* § 6362(f)(3).

(3) A state must adopt the provisions of Subchapter E, including applicable regulations, as they may be amended from time to time during the period in which the collection agreement is in effect. *Id.* § 6362(f)(2)(A).

This means that changes affecting the determination of federal taxable income or the amount of federal tax are automatically adopted; that the administration of the state tax is wholly delegated to the Secretary; that federal, civil, and criminal sanctions apply to the administration of the state tax as if it were a tax imposed by the United States; that federal remedial procedures, including judicial procedures, replace

state remedies and judicial procedures; and that the Secretary represents a state's interest in the tax in the same manner as he represents the interests of the United States. *Id.* § 6361. State courts, however, retain jurisdiction to pass on issues involving the constitution of the state, and the Secretary would not represent the interest of the state in such a proceeding in a state court or in any proceedings involving the relationship between the United States and the state. *Id.* § 6361(d)(1)(B); S. Rep. No. 1050, *supra* at 44, 45.

It is specifically provided that administrative determinations of the Secretary concerning tax liabilities of or refunds owing to individuals with respect to qualified state individual income taxes shall not be reviewed or enforced by any officer or employee of any state or political subdivision of a state. I.R.C. § 6361(d)(3). Tax returns and other information can be made available to the state, however, for any supplementary audit it might care to make, but only the United States may proceed against the taxpayer for any claimed liability. S. Rep. No. 1050, *supra* at 45; Prop. Treas. Reg. § 301.6361-2(d)(3).

Also a state may not impose separate criminal or civil penalties for violation of its income tax law. I.R.C. § 6362(f)(6); S. Rep. No. 1050, *supra* at 57. Fines or other penalties imposed by a federal court or other federal agency for violation of the state income tax would be paid to the state. S. Rep. No. 1050, *supra* at 45, 46.

(4) If a state wishes to make any change in the base or the rate of the tax being collected, it must do so before November 1 of the calendar year for which the tax is collected. I.R.C. § 6362(f)(2)(B); S. Rep. No. 1050, *supra* at 56.

(5) A state may not impose any tax on the income of an individual other than

(a) A qualified resident tax

(b) A qualified nonresident tax

(c) A separate tax on income that is not wage and other business income and that is received or accrued by individuals who are domiciled in the state but who are not residents of the state, as defined in the bill. I.R.C. § 6362(f)(3).

The reference to a separate tax on income that is not wage and other business income means a tax on investment income received by an individual who is a domiciliary of a state but is not a resident of that state, as defined in Code Section 6362(e)(1); that is, a situation in which a person is legally domiciled in one state but is a resident of another by

virtue of the 135-day test. Such a tax would have to be administered separately by a state, but the imposition of the tax would not affect the eligibility of the state to elect federal collection and administration of its qualified state individual income tax. S. REP. No. 1050, *supra* at 56, 57; Prop. Treas. Reg. § 301.6362-7(c).

(6) The taxable years of individuals for purposes of the state tax must coincide with the taxable years for purposes of the federal income tax. I.R.C. § 6362(f)(4). A lack of conformity arising solely from a state's entry into the federal collection system will not disqualify a state tax. The taxpayer would file a short-year return for the state for the first year and thereafter file on the basis of his federal taxable year. The initial short year return would be handled by the state and not piggybacked. S. REP. No. 1050, *supra* at 57.

(7) Married individuals must file jointly or separately for state income tax purposes as they do for federal income tax purposes. I.R.C. § 6362(f)(5).

(8) Entities treated as conduits for federal tax purposes (partnerships, trusts, estates, electing small business corporations, and so forth) must be similarly treated for state income tax purposes. *Id.* § 6362(f)(7). Partners and other recipients of income through conduits would be taxed as they are under the federal income tax. This also means that a partnership would not be subject to an unincorporated business income tax on or measured by net income. S. REP. No. 1050, *supra* at 58, 59; Prop. Treas. Reg. § 301.6362-7(g).

Transfers of Collections to the States

State taxes collected are to be transferred promptly to the states on the basis of estimates made by the Secretary. Taxes collected by withholding are to be transferred to the state no later than the third business day after the withheld taxes are deposited in a federal reserve bank. Amounts collected with returns, declarations of estimated tax, amended returns, and so forth (including criminal penalties) are to be transferred to a state no later than the close of the 30th day after receipt by the Internal Revenue Service. At least once each year, the difference between estimated collections and actual collections (adjusted for credits and refunds) shall be reconciled and the difference charged or credited as the case may be. I.R.C. § 6361(c); S. REP. No. 1050, *supra* at 45-47.

Overpayments and underpayments of the combined tax collected (federal and state) are to be divided on the basis of the respective amounts

required to be paid for the federal tax and for the state tax. I.R.C. § 6361(d)(2). Proposed Treasury Regulation Section 301.6361-3 provides that amounts collected by the federal government that are allocable to qualified taxes are to be promptly transferred to each state imposing such a tax. Transfers are to be based upon percentages of estimated total federal collections and are to be made every third business day. The estimated percentage upon which transfers to states are to be made will be based on forecasts by the Office of Tax Analysis prior to the beginning of each calendar year. This percentage of total federal and state collections estimated to represent qualified state taxes may be revised throughout the year. Prop. Treas. Reg. § 301.6361-3(b). At least once each year, the Secretary shall reconcile the difference between the amount of actual net collections properly attributable to a state and the transfers already made using an estimated percentage of total collections. Prop. Treas. Reg. § 301.6361-3(c).

Whenever the federal collection system begins or ceases to apply to any state tax on any January 1, the change applies to taxable years beginning on or after that date and, for purposes of withholding, to wages paid on or after that date. I.R.C. § 6365(c).

Qualified State Individual Income Tax

As a condition of the election to have the Secretary collect a state individual income tax, the state must impose a "qualified" individual income tax. This may be a "qualified resident tax" alone or a "qualified resident tax" and a "qualified nonresident tax."

(1) Qualified Resident Tax. A qualified resident tax is one imposed by the state on the income of individuals who are residents of the state (see the definition of residence, page 471). A qualified resident tax may be based on federal taxable income as adjusted, or it may be imposed as a percentage of the federal tax as adjusted. *Id.* § 6362 (a)(1), (2).

(a) *Tax Based on Federal Taxable Income.* This is a tax imposed at either a flat or a graduated rate on an amount equal to the individual's taxable income, as defined in Code Section 63, for the taxable year, with the following mandatory adjustments made to the taxable income as so computed:

Subtract: interest on obligations of the United States included in the taxpayer's gross income for the year

Add: the taxpayer's net state income tax deduction for the year

Add: the amount of the taxpayer's net tax-exempt (state and municipal bond) income for the year. *Id.* § 6362(b)(1).

(For the definition of "net state income tax deduction" and "net tax-exempt income," see page 472).

Three other adjustments are permissible at the option of the state. These permissible adjustments are:

(1) The imposition of a state tax on tax preference income, as defined in Code Section 56.

(2) Provision for the allowance of a credit against the state tax for income tax paid to another state or to a political subdivision thereof. *Id.* § 6362(b)(2).

(3) A credit against the qualified tax for all or a part of a general sales tax imposed by the same state or its political subdivisions on sales to the taxpayer or his dependents. This permissible adjustment was added by Section 2116(b) of the Tax Reform Act of 1976, Public Law Number 94-455. If a state elects to permit a sales tax credit, the taxpayer's qualified state income must be adjusted by adding back state and local general sales taxes otherwise allowed as an itemized deduction. *Id.* § 6362(b)(1)(D).

Although taxable state and local bond interest must be added to the state base, there is nothing in the law to prevent a participating state from providing incentives for the purchase of its bonds by making direct payments or tax refunds to its residents for state income taxes collected on its obligations. Such a refund, however, would have to be administered separately by the state. S. REP. NO. 1050, *supra* at 50.

In reference to credits for taxes paid to other states, the Secretary is given broad rule-making powers and can provide various limitations on the credit or on the way in which the limitation is imposed, for example, with respect to either taxable income or adjusted gross income. *Id.* at 49.

Proposed Treasury Regulation 301.6362-4(c) provides that credits for taxes of other jurisdictions may be allowed with respect to every qualified or nonqualified income tax imposed on the taxpayer by another state or its political subdivision or only with respect to certain of these taxes. The credit cannot exceed the amount of the liability for tax to the other jurisdiction and proposed Treasury Regulation 301.6361-1 (c)(1)(ii) lists substantiation requirements for taxes paid to a state that is not a part of the federal collection scheme. The regulations limit the

credit to an amount equal to the resident state's tax multiplied by a fraction in which the numerator is the income taxed by the nonresident state and the denominator is all the income taxed by the resident state.

The House version of H.R. 14370 made provision for a third permissible adjustment—a nonrefundable per head credit with respect to a general sales tax. This adjustment was eliminated in the law as originally enacted in order to avoid putting an undue administrative burden on the IRS. S. Rep. No. 1050, *supra* at 49. In the Tax Reform Act of 1976, however, this concept was restored by allowing a sales tax credit as a permissible adjustment to a tax based on federal taxable income and to a qualified tax imposed as a percentage of the federal tax.

(b) *Tax Imposed as a Percentage of the Federal Tax.* This means a tax imposed at a specified flat percentage of the federal tax as adjusted. (The amount of federal tax before adjustment is defined as the excess of the taxes imposed by Chapter 1 of the Internal Revenue Code over the sum of the credits allowable under Chapter 1, Subchapter A, Part IV, that is, the credits for nonresident aliens for foreign taxes, for partially tax-exempt interests, retirement income credit, investment credit, and overpayments, but not for withheld tax on wages and for federal gasoline taxes.) This base includes the federal liability for the minimum tax. I.R.C. § 6362(c); S. Rep. No. 1050, *supra* at 50.

Mandatory Adjustment. The federal tax must be decreased by the amount that would result from excluding the amount of interest on obligations of the United States that was included in the gross income of the taxpayer for the taxable year.

Permissible Adjustments. At the option of the state, the federal tax may be increased in the amount that would result from inclusion as gross income of all of the following:

(a) The taxpayer's net tax-exempt income for the year

(b) The taxpayer's net state income tax deduction for the year (I.R.C. § 6362(c)(3))

(c) The taxpayer's itemized deduction for state and local sales taxes if the state permits a sales tax credit.

These first two permissible adjustments are treated as a package. Either both or neither must be taken. Adjustment 3 is mandatory if adjustment 5 is allowed.

Additional Permissible Adjustments. At the option of the state, provision may also be made for the allowance against the state tax of:

(d) A credit for income tax paid to another state or to a political subdivision thereof (*Id.* § 6362(c)(4)(A)) or

(e) A nonrefundable credit for all or a part of a general sales tax imposed by the state or its political subdivisions on sales to the taxpayer or his dependents. (*Id.* § 6362(c)(4)(B).)

Adjustments that require a recomputation of taxable income will be made directly to taxable income, and no account will be taken of changes in adjusted gross income under a tax either based on federal income or imposed as a percentage of the federal tax. The proposed regulations direct that no changes are required, for example, in the taxpayer's deduction for medical expenses or for charitable contributions, even though these amounts ordinarily depend on the amount of adjusted gross income. Prop. Treas. Reg. §§ 301.6362-2(c), 301.6362-3(c). Also for a tax that uses a percentage of federal tax, no adjustment shall be made in the amount of any credit against federal tax to which a taxpayer is entitled.

Residence Defined. An individual is a resident of a state with respect to a taxable year only if:

(a) His principal place of residence has been within the state for a period of at least 135 consecutive days and at least 30 days of the period are in the taxable year or

(b) In the case of a citizen or resident of the United States who is not a resident of any state in respect to the taxable year (as determined by the paragraph above), such individual is domiciled in a state for at least 30 days during the taxable year. I.R.C. § 6362(e)(1).

It is also provided that nothing in the bill shall be construed to require or authorize the treatment of a senator, representative, delegate, or resident commissioner as a resident of a state other than the state that he represents in Congress. *Id.* § 6362(e)(1).

Estates. An estate of an individual is treated as a resident of the last state in which the individual was a resident, as determined by (a) and (b), above. *Id.* § 6362(e)(2).

Trusts.

(a) Testamentary Trusts. When a deceased individual is the principal contributor by reason of property passing on his death, the trust is treated as a resident of the last state in which such individual was a resident, as determined under (a) and (b), above. *Id.* § 6362(e)(3)(A).

(b) Nontestamentary Trusts. Any other trust is treated as a resident

of a state for taxable year only if the principal contributor to the trust, during the three-year period ending on the creation of the trust, resided in the state for an aggregate number of days longer than the aggregate number of days he resided in any other state. *Id.* § 6362(e)(3)(B).

There are special rules for determining the principal contributor and the date of creation of the trust. Prop. Treas. Reg. § 301.6362-6(d). It is further provided that if the prescribed rules result in more than one state of residence (or none), the Secretary shall determine the residence of the trust by the application of special rules. I.R.C. § 6362(3)(e)(C). The proposed regulations have these special rules. Prop. Treas. Reg. § 301.6362-6(d)(4).

Items of Adjustment Defined. Two items of adjustment are defined as follows:

(a) Net Tax-Exempt Income. This means the amount of interest on state and local securities, excluding interest on any obligations of the taxing state and its own political subdivisions, that is not subject to the state's own income tax, less any related deductions or adjustments under Code Sections 265 and 1016(a)(5) or (6). I.R.C. § 6362(b)(4); S. Rep. No. 1050, *supra* at 48, 49. A state has the option to tax the interest from all, none, or some of its obligations and those of its political subdivision. Prop. Treas. Reg. § 301.6362-7(b)(2).

(b) Net State Income Tax Deduction. This means the deduction for state and local income taxes allowed under Code Section 164(a)(3), reduced by any recoveries for prior years' income taxes paid to state or local governments that had been deducted under Code Section 164(a)(3). I.R.C. § 6362(b)(3).

(2) Qualified Nonresident Tax. This is a tax imposed by the state on the wage and other business income of individuals who are not residents of the state. It must meet these requirements:

(1) The tax applies only with respect to wage and other business income derived from sources within the state.

(2) The tax applies only if 25 per cent or more of the individual's wage and other business income for the taxable year is derived from sources within the state.

(3) The amount of tax imposed on a nonresident is not more than the tax for which he would be liable under a qualified resident tax if he were a resident and his taxable income consisted of his wage and business income from sources within the state minus a proportion of the

nonbusiness deductions taken into account for purposes of the qualified resident tax. (This deduction is in the same proportion that wage and business income from sources within the state bear to the taxpayer's adjusted gross income.)

(4) The state must also impose a qualified resident tax. *Id.* § 6362(d).

The base of the qualified nonresident tax would be the same as that of the qualified resident tax, that is, either on taxable income adjusted or as a percentage of the federal tax adjusted.

The Treasury Regulations provide for an adjustment for expenses related to the earning of wages that are deductible from gross income to determine adjusted gross income. The Treasury Regulations specify the method of determining income attributable to a state for wage and other business income derived from sources in more than one state. If the income is primarily from personal services or from a personal service business, the income is allocated on a time basis. Business income that is attributable more to capital investment than to services performed is considered to have been derived from sources within the state in which the significant activities of the business are conducted. Separate accounting may be used if the records fairly and equitably reflect this income allocation. Otherwise, the income is apportioned on a three-factor formula consisting of property, payroll, and gross income. Income and deductions from the rental of real property and gain and loss from the disposition of this property, however, are assigned to the situs of the property. Losses attributable to employment or business activity are allocated in the same way that income is allocated. Prop. Treas. Reg. § 301.6362-5(d).

The term *wage and other business income* means:

(1) Wages as defined in Code Section 3401(a) for income tax withholding purposes

(2) Net earnings from self-employment as determined by Code Section 1402(a) relating to the tax on self-employment income for social security purposes

(3) The distributive share of income of any trade or business carried on by:

(a) A trust.

(b) An estate.

(c) An electing small business corporation to the extent such share is includable in the gross income of the individual for the taxable year and would constitute net earnings from self-employment (Code Section

1402(a)) if such trade or business were carried on by a partnership. *Id.* § 6362(d)(2).

As defined, wage and other business income does not include items of investment income that would be definitely classified as income from sources within a state under a conventional state income tax. Code Section 1402(a) excludes rentals from real estate and from personal property leased with real estate unless received in the course of business as a dealer in real estate; dividends and interest are also excluded under Code Section 1402(a) unless received in the course of business as a dealer in stocks and other securities. Under this standard, gains or losses from the sale or exchange of capital assets and the cutting of timber, if Code Section 631 applies, are also excluded.

Existing Federal Statutory Restrictions Not Affected

Federal collection and administration of a qualified state individual income tax do not affect the applicability of the Soldiers' and Sailors' Civil Relief Act provisions in respect to the state income tax. *Id.* § 6362(f)(8).

Federal collection and administration of a qualified state individual income tax do not affect the restrictions of Sections 26, 226A, or 324 of the Interstate Commerce Act or of Section 1112 of the Federal Aviation Act of 1958 in respect to the withholding of income tax from nonresident employees of covered carriers. *Id.* § 6362(f)(9).

Current Collection—Withholding and Declarations

In respect to the application of withholding rules (I.R.C. Chapter 24) and the requirement for declarations of estimated income, the following rules apply:

(1) Resident Tax: An individual is treated as subject to the tax if he reasonably expects to reside in the state for 30 days or more or if he is a resident of the state as defined above.

(2) Nonresident Tax: An individual is treated as subject to the tax if he reasonably expects to receive wage and other business income as defined for 30 days or more during the taxable year. *Id.* § 6362(e)(5).

The Secretary has the authority to prescribe the rates of withholding for state individual income taxes so that he may integrate them with

the rates of withholding for federal income taxes. *Id.* § 6361(a); S. REP. No. 1050, *supra* at 44.

Liability for Tax on Change of Residence

If a person becomes a resident or ceases to be a resident during the taxable year, his liability to a state for a resident tax is proportionate to the tax liability that he would have incurred had he been a resident for a full year and the number of days that he was a resident in relation to the total number of days in the taxable year. Where liability is based on domicile, days of domicile are substituted for days of residence. *Id.* § 6362(e)(4).

Procedure To Elect Federal Collection and Administration

Entry. A state electing to enter into an agreement with the United States for federal collection of its individual income taxes must file a notice of election with the Secretary in such form and with such supporting information as the Secretary may prescribe. The Secretary is directed to enter into an agreement with the state unless, within 90 days after the filing of notice of election, the Secretary notifies the governor of the state that the state does not have a qualified state individual income tax. *Id.* § 6363(a); S. REP. No. 1050, *supra* at 60.

If there is an agreement, federal collection and administration may commence on the date specified in the agreement, but not earlier than the first January 1 that is more than six months after the date of the notice of election. Originally, the federal collection and administration provisions would not become effective prior to the first January 1 that was more than one year after the first date on which at least two states with an aggregate of 5 per cent or more of the federal income tax returns filed during 1972 notified the Secretary of an election to enter an agreement. I.R.C. § 6363(a); Pub. L. No. 92-512, § 204(b), 86 Stat. 945 (1972). Section 2116(a) of Public Law Number 94-455 reduced the threshold for election by states to participate. Now, just one state, without satisfaction of a percentage of federal returns filed requirement, may implement the federal state tax collection mechanism.

Withdrawal. If a state wishes to withdraw from a collection agreement, it files a notice of intention to withdraw. Withdrawal is effective on the date specified, although it may not be earlier than the first January 1 that is more than six months after the date of notice. I.R.C. § 6363(b)(1).

Any change in state law that has the effect of causing a tax to cease to be a qualified state individual income tax shall be treated as an intention to withdraw from the agreement. In such a case, the Secretary notifies the governor of the state that the change in state law will be treated as an intention to withdraw. The Secretary's notice has the same effect as a notice by a state of an intention to withdraw that had been received on the effective date of the change in state law. *Id.* § 6363(b)(2).

Transition. There are transitional provisions to cover the case in which the federal collection and administration system ceases to apply on a day other than the last day of a taxpayer's taxable year. A state may also provide by law for the transition to or from a qualified state individual income tax to the extent necessary to prevent double taxation or other unintended hardships or to prevent unintended benefits under state law. These transitional provisions may be administered by the Secretary, the state, or both, as the Secretary may provide. *Id.* § 6363(c).

Judicial Review of Secretary's Determination

A determination by the Secretary that a state does not have a qualified state individual income tax may be reviewed on application of the state by the United States Court of Appeals for the circuit in which the state is located or by the United States Court of Appeals for the District of Columbia. When a copy of the petition for review is transmitted to the Secretary, he is required to file in court the record of the proceedings on which he has based his action. 28 U.S.C. § 2112. The judgment of the Court of Appeals is subject to review on *certiorari* or certification. 28 U.S.C. § 1254. At the request of either the Secretary or a state, any judicial proceedings for a review of the Secretary's determination in this respect shall receive preference for an expeditious hearing. I.R.C. § 6363(d).

Miscellaneous Provisions

The Secretary is given power to prescribe necessary and appropriate regulations to carry out the purposes of Subchapter E. *Id.* § 6364. Proposed regulations were printed in the *Federal Register*, Volume 42, Number 189, on September 29, 1977. Written comments and requests for a hearing should have been posted by December 14, 1977.

He is also authorized to make modifications necessary or appropriate to reflect differences in the federal and state taxes or differences in the

situations in which liability for such taxes arise. *Id.* § 6361(a); S. REP. No. 1050, *supra* at 44.

Conforming amendments include refunds or credits of qualified state individual income tax within the reporting provisions of Code Section 6405 (Joint Committee on Internal Revenue) and review of deficiencies under the tax court small claims procedure. Pub. L. No. 92-512, § 203(a), (b), 86 Stat. 944 (1972).

In addition to providing an optional sales tax credit and to decreasing the entry threshold into the federal collection system, the Tax Reform Act of 1976 makes it certain that no fee or other charge shall be imposed on any state for the collection or administration of its qualified state individual taxes. I.R.C. § 6361(a).

THE CASE FOR THE FEDERAL COLLECTION SYSTEM

Federal collection of state individual income taxes is supported on the grounds that it will improve the overall efficiency of tax administration and provide additional revenue to the states. Specifically, it is urged that federal collection will accomplish the following: (1) eliminate duplication of administration; (2) reduce the case load in state courts; (3) make it much more difficult for individuals to avoid state taxes by providing a standard definition of residence; (4) speed up the flow of income tax revenue into state treasuries because the federal withholding system expedites the deposit of withheld taxes; (5) provide a one-time windfall revenue effect for the states; (6) simplify tax compliance by the one-return system for both federal and state income taxes; and (7) be considerably more effective than that of the states, measured by the cost of collecting a dollar of income tax revenue.

Duplication of Administration

It is likely that federal collection will eliminate much of the duplication of administrative effort involved in the routine receipt and processing of returns. This would not be true, however, in respect to compliance and enforcement activities, including office and field audit operations, where, at present, *combined* federal and state efforts cover only a relatively small percentage of all individual income taxpayers. All the states currently imposing individual income taxes have entered into agreements with the Internal Revenue Service that provide, among other things, for the exchange of information, including audit reports,

between the IRS and the respective states. Thus the state tax departments are advised of federal tax adjustments and changes and the IRS is advised of similar adjustments and changes made through state enforcement and compliance activities so that duplication of effort is largely avoided. The important point here, which will be discussed in more detail later on, is that the transfer of the complete responsibility for collection of the state tax to the Internal Revenue Service would mean that the nonduplicated enforcement and compliance activities now carried on by the state tax departments would be terminated, along with the duplicated processing operations.

It has been suggested that those states with aggressive enforcement activities consider supplementing the federal audit efforts. A state would have reasonable access to tax returns and other appropriate records and information relating to its tax for the purpose of supplemental enforcement. The audits or examinations of tax returns, however, would be conducted under the supervision and control of the commissioner. The commissioner would determine which audits would be made and his delegates would determine the final results of those audits. It is doubtful that a state could effectively administer a supplemental enforcement program under these conditions.

It might also be noted that the complete elimination of routine income tax processing activities still may not be practicable for those states electing to have federal collection. For example, if a state imposes the tax on investment income of domiciliaries (I.R.C. § 6362(f)(3)(C)) it must assume full responsibility for the administration of the tax, including all processing and enforcement activities. Similarly, if state tax policy calls for the use of the income tax credit mechanism to achieve such objectives as property tax relief either generally or for the elderly or the poor, these programs must be wholly administered by the states. Where size of income is a factor in the credit, an income tax return or something akin to it must be filed by the applicant and processed by the state. Since the income tax credit appears to be increasingly accepted, the likelihood is that in many instances state income tax departments would have to continue some, perhaps substantial, processing operations, even under the federal collection program. Of the 40 income tax states responding to a 1977 survey made by the state of Wisconsin, 33 reported some form of tax credit program that could not be administered by the Internal Revenue Service under the law. Thus the anticipated savings in processing costs would be to some extent offset by the need to retain at least a part of these operations.

Caseload in State Courts

Under the provisions of Public Law Number 92-512, a state that elects federal collection delegates complete responsibility for the collection of the state tax to the United States. Judicial proceedings involved in these determinations take place in federal courts, rather than in state courts, save, of course, those cases involving a state constitutional question. This, plus the fact that there is a substantial background of federal decisions and precedents, should result in the practical elimination of individual income tax litigation in the courts of electing states. This appears to be a reasonable expectation.

What needs to be considered, however, is the practical importance of the advantage of reduced caseloads in state courts when weighed against some of the problems that federal collection will raise for the states. Actually, the present individual income tax caseload in state courts does not appear to be significant. Those cases that are litigated in the state courts usually stem from audit and other enforcement activities conducted by the state tax department. When this is the situation, the termination of the audit and enforcement activities carried on by the state means that many of these cases will simply never be brought to court. The reduction in the state court docket of tax cases is thus achieved as a result of a reduction in enforcement activity and not by virtue of a more efficient use of the federal courts.

In many states, moreover, federal precedents and rulings are already substantially followed, since federal adjusted gross income or federal taxable income, with modifications, is widely used as the starting point for the determination of taxable income for state individual income tax purposes. Under this system, the state legislature retains and often exercises much more control over the state tie to the federal definition of taxable income than is possible under the Public Law Number 92-512 collection system, under which only a limited number of adjustments or modifications is permitted. From the standpoint of state officials, the question presented is whether the possibility of a slightly broader use of federal income cases and rulings outweighs the advantages of retaining a substantially greater degree of control over the state tax base than would be the case if the state were to elect federal collection.

Faster Collection of Withheld Taxes

One of the advantages foreseen for the federal collection system is that amounts withheld for state income taxes will flow into state treasuries

more quickly than under existing state procedures. Generally speaking, the states require a monthly deposit and the federal government requires a weekly deposit of withheld taxes. A review of state withholding practices was made in 1972 and again in 1977. The more recent study showed that of the 42 jurisdictions that require general withholding of individual income taxes, 34 require monthly deposits, either regularly or when the amount withheld meets a specified minimum. Eight states, including five of the 34 states, require semimonthly deposits if a specified amount is owing. The number of states requiring monthly withholding deposits has increased by three since 1972, while the number of states requiring semimonthly deposits has increased by four. Under federal law, employers must make a deposit of withheld taxes within three banking days after the end of each quarter of a month if the amount due, including social security taxes, is $2,000 or more.

Under the provisions of Public Law Number 95-512, an electing state's estimated share of these combined deposits for federal and state taxes must be transferred to the state not later than the close of the third business day after the withheld taxes are deposited in a federal reserve bank. Other amounts of an electing state's income tax collected by the IRS (remittances with returns, declarations, and so forth) are to be transferred to a state within 30 days after receipt by the IRS.

Weekly transfers of withheld state income taxes would undoubtedly result in a speed-up of the current collection process for all states electing federal collection. In addition, there would be a one-time acceleration of state collections from withholding in the fiscal year during which federal collection first becomes effective. This windfall is anticipated because transfers to a state from weekly federal deposits would include some amounts that would ordinarily be collected by the state in the following fiscal year.

The amounts involved in the current speed-up and the windfall effect would vary substantially among the states. The greatest impact would occur in the quarterly withholding states and the least in the states with semimonthly withholding payments. For example, in the semimonthly payment states, one half of the semimonthly collections would be received one week earlier than under the existing system, and the fiscal year windfall effect would be the same, that is, about one week's withholdings. In the quarterly payment states, both the acceleration of current payments and the windfall effect would be substantial, the latter accounting for almost one whole quarter's collections. It should be noted, however, that most of the speed-up in current collections and most of the windfall effect in the quarterly withholding states would be

attributable to the extended withholding period fixed by existing state laws rather than to any unique feature of the federal collection system.

In view of differences in practice from state to state, each state will have to make its own appraisal of the impact of federal collection on cash flows from individual income tax collections. Several factors need to be considered. One is the feasibility of the three-day transfer period on withheld collections. Another factor is the rate of withholding for state income taxes, which is to be prescribed by the Secretary "so that he may integrate them with the rates of withholding of federal income taxes." S. Rep. No. 1050, *supra* at 44. In practice, there is now substantial overwithholding of income tax in many, if, indeed, not most, states. (When withholding rates have been prescribed by the Secretary, state officials will be able to appraise this factor more precisely.) The length and timing of deposits of withheld taxes may have some bearing on arrangements between banks and state treasuries for services performed by banks. The delayed receipt of payments made by declarations in the last quarter of the fiscal year may offset, to some extent, the speed-up in withholding payments in that quarter, since payments with declarations are subject to the 30-day remittance standard. The anticipated windfall effect itself in the first fiscal year of federal collection may be negligible if it has been the practice in a state to defer closing the fiscal year books for two weeks or more.

In summary, it might be said that federal collections will speed up cash flows from withheld taxes and that the amount of the speed-up will vary from state to state. It should also be added that a substantial, although not equivalent, speed-up could be achieved in many states by changes in state laws. Where the extent of the speed-up is relatively small, as in the semimonthly withholding situations, an appraisal of all related factors is essential, as there may be some offsetting flow-of-funds disadvantages involved in the changeover to federal collection.

The proposed regulations make it clear that transfers to the states will be made no less frequently than every third business day, unless the state agrees to accept transfers at less frequent intervals. These distributions, however, shall be made on the basis of an estimate that is to be made by the Office of Tax Analysis prior to the beginning of each calendar year concerning what portion of the aggregate collections for the ensuing year can be attributable to the federally collected state taxes. Modifications of the estimated percentage may be made during the year. Prop. Treas. Reg. § 301.6361-3.

Unless consideration is given to expected real and inflationary growth in tax collections in arriving at the factor to be used for making these

transfers, a negative effect on state cash-flow will result. In each of the past four fiscal years, state individual income tax collections have grown as follows:

Fiscal Year	Percentage Increase
1973	19.9%
1974	9.2%
1975	10.0%
1976	14.0%

If the Treasury bases its estimate on prior year collections without anticipating growth accurately, the state is denied access to substantial revenue throughout the year. In the state of Wisconsin, for example, individual income tax collections between 1976 and 1977 fiscal years increased by $160 million.

Simplification of Compliance Burdens

A principal advantage expected to be achieved by federal collection would be the simplification of the filing requirements for individual taxpayers. Under federal collection, a taxpayer would file a single return with the Internal Revenue Service covering both federal and state income tax liability and, in the computation of state tax, would use a base that, save for the few mandatory or permitted modifications, would be identical to the federal tax base.

Since most states already use federal adjusted gross income or taxable income as the starting point in computing taxable income for state purposes, the extent to which the filing process would be simplified is probably rather modest for those taxpayers filing in only one state. For practical purposes, the improvement would be only that resulting from the elimination of one or more of the modifications to federal adjusted gross income or to federal taxable income now required by the state. From the taxpayer's standpoint, this would be a mixed blessing if the modifications eliminated would have the effect of reducing his taxable income for state purposes. As noted elsewhere, this simplification process would also entail the elimination from the combined federal-state return of credits allowed by a number of states for property tax relief or reduction, including the so-called circuit breaker. Although a state could continue these credits, they would have to be separately administered through an application or return that in many cases might require substantially the same information that is shown on an income tax return.

For a nonresident filing in two or more states electing federal collection, the computation of taxable income would be simpler than at present because the limitation on the number of required or permitted modifications has greater practical significance for a nonresident than for a taxpayer filing in a single state. On the other hand, if the nonresident would file in a combination of electing and nonelecting states, his situation might not be greatly different from that which presently prevails.

Aside from the fact that the single return to be filed for the states electing federal collection would be sent to a single office, it probably would not provide any saving in time or trouble for the taxpayer. It is contemplated that in addition to the federal return, the taxpayer would have to file a detailed separate schedule for each state in which he is taxable. For a taxpayer filing in his state of residence only, a federal return plus a separate schedule for that state would not be much different from a federal return and a separate state return already substantially based on the federal return.

Federal collection would cause some electing states to lose the flexibility that they now enjoy in the use of reciprocity agreements to limit double filing of returns and double withholding in cases in which residents of one state work in another. Under these reciprocal agreements, it is provided that each state taxes its own resident and does not tax the nonresident from an agreeing state. The simplification achieved here concerning filing and withholding is regarded as significant from the standpoints of the taxpayers, the tax administrators, and the employers involved. Although these agreements are not universal, they are in effect in a number of states. The adoption of only a qualified resident tax would avoid duplicate filings and withholding under the federal collection approach, but might have substantial adverse revenue effects for some states. This latter factor is, perhaps, the reason that the reciprocal exemption approach has not evolved into an outright exemption of income earned in a state by nonresidents. Presumably, it would also constitute an equally strong argument against the enactment of only a qualified resident tax by a state electing federal collection.

Other points must be considered in the appraisal of the advantages expected to be derived in respect to filing and withholding requirements under federal collection. First, the IRS may be put to considerable trouble in sorting out withholding reports for two or more states involving nonresidents because of the requirement that the tax be withheld if the individual may be reasonably expected to earn income in a state for 30 days or more. The burden on the employer may also be

heavier in these circumstances, especially when compared with the procedures in the states with reciprocal agreements. Second, the residence standards laid down in Public Law Number 92-512 pose some complications when an individual changes his place of residence. Under these rules, he might be taxable as a resident in two or three states. Returns of that type would have to be identified and handled manually.

All in all, simplification in filing requirements might be achieved for some taxpayers under the federal collection approach, but, at best, the expected improvement would have to be characterized as modest. In some circumstances, this simplification would be achieved only at the expense of further complicating the administrative process for the IRS. Finally, some of the flexibility that the states now have in the matter of filing and withholding requirements for nonresidents would be lost under federal collection.

SOME PROBLEMS FOR STATES UNDER A FEDERAL COLLECTION SYSTEM

The prospects for electing to come under a federal collection system may have an appeal for a few states concerned with agency operating costs and interested in fully utilizing the administrative capabilities of the Internal Revenue Service. The preceding discussion analyzed those advantages suggested for a combined income tax administration. The withholding windfall issue, the effect on state court caseloads, what happens to taxpayer return filing requirements, and the administrative consequences of withholding on nonresidents are all potentially quantifiable factors. After regulations are promulgated by the Secretary of the Treasury, each state should be able to predict with reasonable certainty how it shall fare in these respects under a federal collection system. There are other issues, however, that are more qualitative, though no less important, and are worthy of consideration. The effects of federal collection should be considered from the standpoint of what it may do to a state's existing flexibility in determining its own tax program, its consequences on the availability of needed revenue data, its compatibility with the state's constitution, and its effect upon a state's autonomy.

Flexibility of State Tax Systems

States that enter into a collection agreement expose their tax structures to the changes in the federal system. Any changes in the federal individual income tax structure, for example, modifications in rates,

deductions, exemptions, exclusions, or other definitions of taxable income, would be reflected automatically and immediately upon an agreeing state's tax structure and revenue. The state of Nebraska (which now bases its tax on a percentage of federal tax liability) has estimated that the Tax Reform Act of 1969 cost that state almost $19,000,000 in lost revenue.

This type of loss could be offset by raising the tax rate (or rates in the case of a state using federal taxable income). The actual outcome, however, of these changes is most often immediately unpredictable. Accordingly, a state would not know how to recoup its losses accurately. Moreover, Congress appears to have recently adopted the habit of enacting tax legislation in the latter part of the year. Both the Tax Reform Act of 1969 and the Revenue Act of 1971 were passed during the last months of those years. The Tax Reform Act of 1976 became effective in October, a time when most state legislatures were not in session.

In one state, Oregon, a group of legislators, in cooperation with the state Bar and Accounting Society, succeeded in changing Oregon's law to adopt the federal personal income tax base. The motivation for change was to provide the state's taxpayers with a simplified form for reporting income and to give them one set of regulations and laws to follow. At the time the Oregon Tax Simplification Bill was introduced in the legislature, it was recognized that complete adoption of the Internal Revenue Code would have a negative revenue effect for the state. In order to overcome this but maintain the advantages of tax conformity with the Internal Revenue Code, the legislature adjusted the tax rates (upward). Additionally, it provided that all future changes in the federal code would become law for Oregon. This change was adopted in June 1969.

After adoption of the federal base, Oregon officials learned that subsequent Congressional considerations for change would result in unanticipated revenue losses of $30 million. The changes in the Internal Revenue Code were made in December 1969.

Oregon's governor proposed to accept these revenue losses without changing Oregon tax law for the sake of continuing the desirable benefits of simplification and conformity and recommended offsetting these losses by severely cutting back on expenditures and adjusting upward other revenue sources. This, however, was not the last of it. During 1971, Congress again considered tax changes that predictably could have further decreased Oregon revenues. These changes were of such magnitude that the state felt it could not absorb the lost revenue. In anticipation of a change at the federal level, the governor of Oregon

called the legislature into a special session to terminate the automatic adoption of federal law changes occurring after December 31, 1971.

The effects of the Revenue Act of 1971 were offset by discontinuing automatic adoption of federal income tax changes, saving Oregon approximately $14 million, reducing the state budget by $12 million, and increasing the tax on cigarettes by 5 cents per package.

Changes in the federal revenue laws in 1969 and in 1971 resulted in $44 million in lost revenue for Oregon. Neither congressional act could have been forecast with any certainty when Oregon adopted the federal base in June 1969. The effects of the Revenue Act of 1971 necessitated a call for a special session of the legislature, severe cutbacks in expenditures for needed state programs, increases in other taxes, and the adoption of a fixed date of reference to the Internal Revenue Code. C. Mack, Experience in the Use of the Federal Personal Income Tax Base (paper presented at the annual meeting of the National Association of Tax Administrators, St. Paul, Minnesota, June 11, 1972).

With the passage of time and additional changes in the federal code, it could be predicted that the simplification and conformity so greatly desired would be affected. In 1975 Oregon switched back to adoption of the current Internal Revenue Code, with certain exceptions. The tug of war between the conflicting goals of simplification and conformity versus revenue stability played a part in bringing about the frequent and, possibly, confusing changes for taxpayers, as well as tax administrators.

States that currently base their tax on federal definitions of income and deductions or on federal tax liability do have problems with respect to changes in the federal code. They can adapt to these changes, however, by calling special sessions of the legislature for the purpose of modifying tax rates for the current year or future years or both. Although administratively awkward, it is possible, in this way, to modify the consequences of late-year changes enacted by Congress. Under the federal collection system, the states are prohibited from making compensating rate changes after October 31 of the year to which such rates apply. The effects of changes made in the Code by Congress after that date will have to be borne by the states, by making compensating adjustments in the tax base or in rates for other types of taxes or by overcompensating in the individual income tax rates for the following year.

State Autonomy

One of the most delicate issues to consider regarding federal collection of state taxes is the effect such a system would have on the legislative prerogatives of the state. State legislators who vote for such a system must recognize that by so doing they are accepting Congressional philosophy and policy in respect to the definition of tax base and taxable income, that is, deductions, tax credits, depreciation, depletion, capital gains, the level set for exemptions, and so forth. Consenting states will have two choices in fixing their tax rates: (1) to impose a state tax as a percentage of federal tax or (2) to impose a single rate or a series of graduated rates of tax against modified federal taxable income. The ability to allow special tax credits to be taken against the income tax will be substantially restricted. For example, a property tax relief credit against income tax based upon an age and means test and special credits for contributions to educational institutions are not allowed.

If state income tax revenues are to be tied closely to federal tax base and federal tax rates, the states are going to have a much more direct interest than previously in congressional tax law changes. Charles F. Conlon posed these questions:

> [A]s a practical matter, would this vested interest of the states restrict the freedom of Congress to make major changes in federal laws to carry out some new fiscal policy? Or, would this close tie to the federal income tax system tend to be advantageous from the standpoint of fiscal policy in that if the states accepted the federal changes without revising their own tax rates, the fiscal effects of the change would be reinforced? The alternatives involved in these questions cannot be dismissed as insignificant. Conlon, *Federal Participation in State Tax Administration,* 24 NAT'L TAX J. 369 (1971).

In analyzing H.R. 14370, the California Senate Office of Research reviewed the proposed federal collection system and observed:

> [W]hile federal collection and administration is optional, any state which elects the program also must abdicate policymaking power. A state, as a sovereign power within the federal system, has the responsibility to make its tax structure equitable vis-a-vis the classes of its taxpayers. What may be equitable on a national scale may not be appropriate for state income tax purposes. Moreover, the income tax should complement the other taxes making a well balanced state tax structure. Report to Senator James R. Mills, Chairman, Senate Rules Committee (June 29, 1972).

As pointed out elsewhere, many states have granted income tax benefits to classes of its taxpayers especially in need of consideration. Many, if not all, of these benefits are eliminated under the federal collection system. Any separate program administered by the state that is permitted under Public Law Number 92-512 but not as part of a qualified income tax will decrease the benefits of federal collection and administration.

The Internal Revenue Code contains provisions that are coming increasingly under attack and are believed, in some quarters, to be unnecessary and operating to the advantage of certain interest groups and to the detriment of others. Some states allow them, others do not. Some of the more prominent examples include the taxation of 50 per cent of capital gains, rapid write-off of depreciable assets, percentage depletion allowances, and investment credits. Those states that have found little need for incentives of this kind and that use federal income as a base have required appropriate modifications to eliminate these items in arriving at net taxable income. Adoption of a federal collection system for these states would represent a considerable change in policy and a departure from the existing base from which income tax revenues are derived.

Constitutional Problems

In a number of states, there are constitutional considerations that must be taken into account. Under Public Law Number 92-512, changes in the federal law could automatically affect the state tax base. In many states, it appears that a legislature may adopt by reference the provisions of the Internal Revenue Code that may exist at the time of adoption of the state statute. The right to base state tax liability on provisions of the federal law that may be enacted after adoption of the state statute, however, is open to doubt in a number of states. Constitutional amendments would be required in some states in which exemptions, deductions, tax rates, or uniformity requirements are written into existing constitutions.

The Illinois constitution provides that a tax on or measured by income must be imposed at a flat rate. This would eliminate one of the two alternative methods allowed under the federal collection system for Illinois and would require that it use a flat rate tax against federal taxable income modified, if it were an electing state. The Illinois constitution, on the other hand, does permit the legislature to adopt by reference the laws of the United States as currently enforced and as they

might be amended in the future for arriving at the amount of income subject to taxation. ILL. CONST. OF 1970, art. IX, § 3(a), (b).

The Supreme Court of Pennsylvania has held that a flat rate state income tax applied to federal taxable income violates the state's uniformity clause and is invalid. *Tilghman v. Commonwealth* (1971). It is extremely doubtful if either alternative allowable under Public Law Number 92-512 could pass constitutional tests in Pennsylvania.

Many states' constitutions require a balanced budget and do not allow deficits. Because of the fiscal uncertainty involved in basing a state tax on federal income or tax liability, such states will be put in an impossible position of having to adjust tax rates for a base change with insufficient time to be sure of what the effects will be. Public Law Number 92-512 requires that a state change may not be made later than October 31 of the year in which the change is to take effect. Federal tax law changes have been known to occur considerably later than that date.

Availability of Revenue Data

The states have a vital interest in the information or data that may be obtained from income tax returns filed. Currently, state income tax return information is regularly used for a variety of purposes. Tax departments find it beneficial to compare gross receipts reported on income and sales tax returns; cost-of-goods-sold schedules (especially inventory information) and asset depreciation schedules are used in personal property tax administration; information on sources of income and depreciable assets held are often reviewed by inheritance or estate tax personnel. In many states, the tax departments are asked by public universities to assist them in making determinations of whether particular students qualify for resident tuition; information from available state tax returns is used for this purpose. Similarly, state highway departments and natural resource agencies refer to tax information for assistance in making judgments on intended purchases for public purposes. In at least one state (Wisconsin), the conservation wardens check all questionable resident hunting and fishing permits against the state's income tax roll. Individuals who claim residency for fishing license fee purposes and nonresidency for tax purposes are either fined under the fish and game laws or required to file or to amend tax returns previously filed. It is doubtful whether information for these purposes would be available under Public Law Number 92-512.

Data now accessible on a current basis regarding taxpayer class income levels and changes in these levels, income-by-source characteris-

tics, industry activities affecting withholding, and so forth are necessary for revenue forecasting purposes. Without information of this nature, state revenue estimators have only the amounts of prior year dollar distributions to their state on which to base estimates. With such limited information, revenue forecasting would be extremely hazardous, particularly in situations where rapid estimates would be necessary in order to cope with late-in-the-year passage of federal tax laws.

THE REAL ISSUE: THE EFFECT ON THE SELF-ASSESSMENT INCOME TAX SYSTEM

Without question, the most important consideration to keep in mind when evaluating the consequences of the federal collection system is the effect on our self-assessment income tax system if all state income tax enforcement activity were to cease. Tax administrators particularly disagree with the statement in the Senate Report on H.R. 14370, which finds that "a significant increase of state tax revenue should result from consolidation of the administration of Federal and State income taxes." S. REP. NO. 1050, *supra* at 19. That report places an emphasis on the savings that could be achieved by a combined administration of income taxes. Admittedly, a case can be made for savings as far as processing costs are concerned. (See, however, the discussion of this argument on pages 477-78. The same argument cannot be made with respect to enforcement costs of the states.

Comparative Efficiencies

One of the indicators of efficiency used in comparing relative effectiveness of federal versus state tax administration of individual income tax laws is agency operating costs per $100 of taxes collected. Total federal tax collections are approximately eight times greater than total state individual income tax collections, whereas the Internal Revenue Service's "efficiency factor," based on costs per $100 of tax collected, appears to be only three times better than that of the states. Since collection costs are relatively fixed per number of taxpayers, it is believed that the Internal Revenue Service appears to be more efficient in terms of costs per $100 collected because the United States' tax burden on the individual is about eight times larger than that of the states taken collectively.

A simple, hypothetical example to demonstrate the differences that

tax rates have on performance measured by costs per dollar of tax collected may be constructed. Assume that 2 identical taxpayers, with $20,000 taxable incomes, are audited. One taxpayer is audited by an IRS agent and the other by a state (Wisconsin) auditor. Both tax auditors find identical errors resulting in $10,000 additional taxable income within the same amount of examining time. The federal tax deficiency is approximately $3,500, whereas the state additional assessment is $1,040. It cannot be concluded from these facts that the state auditor is less efficient than the IRS agent; his efforts produced the same amount of untaxed income and he completed his assignment in the same amount of time. It just happens that the effective rate of taxation in his state for this income level is 29 per cent of the tax on the same income imposed by the United States.

Surveys of the States

The 1972 National Association of Tax Administrators (NATA) Survey. In 1972 NATA gathered data on enforcement activities in 18 states (Alaska, Arizona, Arkansas, California, Hawaii, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, New York, North Carolina, Oregon, South Carolina, Virginia, Wisconsin and the District of Columbia). These 18 states represented 40 per cent of the nation's population and accounted for 63 per cent of all state individual income taxes collected in 1970. Enforcement activities in those states accounted for $231 million additional collections, which represented 3.63 per cent of their total individual income tax collections. According to the 1970 annual report of the Commissioner of Internal Revenue, in 1970 the Service examined 1,672,000 individual and fiduciary returns, from which it collected or expected to collect $895 million. In the same year, the Service collected $2.5 billion in delinquent taxes. Thus the 1970 enforcement activity of Internal Revenue Service yielded $3.4 billion or 4.1 per cent of total individual and fiduciary income tax collections. When the difference in rates of taxation was taken into account and the modest compliance efforts of some of the sampled states were considered (four states had no field audit programs; six states had less than 25 man-years devoted to enforcement activities), it did not seem that the states represented in that sample were collectively less efficient than the Internal Revenue Service.

Other statistics of interest found in the 1972 survey are as follows:

(1) *Enforcement Collection and Costs*	
Collection from audit and compliance activities	$ 231,909,000
Audit/compliance costs	22,507,000
Collections in excess of costs	$ 208,402,000
Enforcement collections per $1 costs	$ 10.30
(2) *Overall Program Costs and Total Collections*	
Total collections	$6,387,033,000
Overall program costs (including processing, printing, taxpayer information and education, training, and records retention)	68,260,000
Collections in excess of total costs	$6,318,773,000
Receipts per $1 cost	$ 91.95
(3) *Total Number of Man-Hours Devoted to Audit and Compliance Activities*	4,141,000

It was conceded, however, that the existence of a large federal enforcement staff contributed to the effectiveness of state compliance and audit activity, as measured in the 1972 study. It was not suggested that the efficiency of state enforcement programs, as measured by the cost-productivity ratios cited in the 1972 survey, was completely independent of federal compliance and audit activity. (A second study, completed in 1977 and summarized below, sought to identify and to quantify the effects of federally conducted audit activity so that the amounts collected by the states as a result of federal IRS information (Revenue Agent Reports (RAR's)) could be considered as a per cent of total state audit activity or enforcement activity or both.)

The effectiveness of enforcement programs was demonstrated in the data gathered from the 18 states in the survey. The additional collections from compliance pursuits ($231.9 million) far exceeded direct enforcement costs ($22.5 million) and more than paid for total program expenditures ($68.2 million).

The 1977 Wisconsin Survey of States. In 1977, data on enforcement activities were again requested of the states (a summary of responses to the questionnaire is available on request). Of the 42 states administering a broad-based individual income tax, 40 responded. The exceptions were the states of Delaware and Nebraska. The 40 states reported additional collections as a result of enforcement activities amounting to $537 million. This amount may be broken down into $267 million attributable to audit activities and $270 million attributable to compliance/delinquent collection activity. Of the $537 million enforcement total,

$89 million may be attributed to information taken from 720,000 RARs, which were received by the 40 states from the IRS. This $89 million represents 16.6 per cent of the total states' enforcement collections. If considered as a per cent of audit collection only, the federal assistance represents 33 per cent of audit collection. In any consideration of the impact of IRS audit activity on state enforcement collections, it is notable that of the 720,000 Internal Revenue Service RARs distributed to state tax departments in 1976, over 408,000 or 57 per cent were provided to the states of New York and California. On the basis of the RARs, California and New York collected an additional $47.8 million or 53 per cent of the total attributed to IRS assistance.

Additional information was readily available from 28 of the 40 responding states as follows:

Enforcement Collections and Costs	
Audit collections	$228,692,300
Compliance collections	259,837,300
Total enforcement collections	$488,529,600
Audit costs	$ 26,562,900
Compliance costs	16,802,400
Total enforcement cost	$ 43,365,300
Collections in excess of cost	$445,164,300
Enforcement collections per $1 cost	$ 11.27
Total number of employee years devoted to audit	1,768
Total number of employee years devoted to compliance	1,230
Total audit and compliance years	2,998
Total employee hours at 2,080 hours per employee year	6,235,800

In addition to a direct loss of collections, an indirect, immeasurable but certain loss of revenue of even greater proportions would result from reduced enforcement levels. Although the complete responsibility for the enforcement and collection of the state tax is delegated to the Secretary of the Treasury, as mentioned earlier, it is possible that tax returns might be turned over to the state for audit or examination. Since the results of the audit would have to be handed over to the IRS for action against the taxpayer, however, it is unlikely that, under these circumstances, a state would continue such activities. Thus a corresponding reduction would occur in total individual income tax compliance efforts for such states, including a reduction in the number of

returns examined by office or field audit, unless the federal government would choose to replace state efforts with its own. Since Public Law Number 92-512 does not provide additional funding for the Internal Revenue Service, it is unlikely that state enforcement activities would be replaced to any material degree.

The Internal Revenue Service now examines approximately 2.25 per cent of the returns filed. Based on IRS releases about its audit coverage and from the survey data on distribution of RARs among the states, it becomes an established fact that the IRS audits tax returns with different frequency in different states. The mixture of support for a combined audit effort within any jurisdiction differs, with the total effect dependent on the IRS's allocation of its resources and on the state's willingness to support an enforcement function.

A reduction in the audit level of a participating state's taxpayers will have an impact on the self-assessment atmosphere in that state. There is general agreement among state and federal tax administrators that the degree of accuracy on any type of return is related to the degree of enforcement of those taxes. The willingness of some to gamble on an erroneous return increases with the probability that it will not be examined.

IRS's Enforcement Capacity

In order to analyze the federal government's ability to "take up the slack," it is useful to examine the position of the IRS with respect to its capability to provide for adequate enforcement. In its appropriation request for the 1973 fiscal year, IRS asked for an additional 2,988 positions, 2,135 of which were for additional collection and audit personnel.

Commissioner of Internal Revenue Johnnie M. Walters stated to the House Appropriations Subcommittee:

> As the committee knows, audit capability has been stretched increasingly thin over the past several years. A *certain* result of this weakened enforcement is lost revenue, in terms of thousands of productive audits that cannot be made. That is important; however, a more critical matter of concern is the *potential* deterioration in the levels of voluntary compliance. It is not merely important—it is absolutely necessary that our tax system, based on voluntary compliance, be maintained in a healthy and vigorous state. Our tax law enforcement must be adequate to prevent deterioration in the generally high levels of compliance.
>
> As evidence of serious noncompliance accumulates, we are concerned that our tax law enforcement capability is not adequate to

> assure that noncompliance will be corrected and that high compliance will be maintained where it does exist. Audit coverage clearly is spread too thin. The lack of sufficient technical manpower to improve tax enforcement significantly continues to be a serious concern. REPORT OF HEARINGS BEFORE A SUBCOMM. OF THE HOUSE COMM. ON APPROPRIATIONS, 92d Cong., 2d Sess. 3 (1972).

In commenting on the service's audit program, Walters cautioned that the nature of the activity and the size of its workload have been subject to a series of restrictions and that audit activity has unavoidably failed to keep pace with workload demand.

> In the decade from 1963 to 1973, the total number of returns filed will have risen from 97.8 million to 113.6 million, an increase of 16 percent. More importantly for Audit, for the same period the volume of returns constituting significant Audit workload will have risen from 8.6 million to 33.8 million, a 295 percent increase.
>
> Meanwhile, Audit technical manpower, revenue agents, and tax auditors *available to handle this workload,* have been declining between 1968 and 1972. There has been a drop of 2,270 man-years, or 15 percent. In short, while Audit workload has been climbing rapidly, available Audit manpower has moved in the opposite direction. The country cannot afford this.
>
> Total Audit strength remains roughly the same as in 1963. However, the increasing need for technical manpower for other critical programs has resulted in a decline in staff available for income, estate, and gift tax examination. *Id.* at 7, 8.

Data taken from the annual reports of the Commissioner of the Internal Revenue show that the number of individual and fiduciary income tax returns examined has fluctuated over the past few years.

Year	Number of Returns Examined (000)
1964	3,236
1965	3,092
1966	3,092
1967	2,768
1968	2,563
1969	2,196
1970	1,672
1971	1,346
1972	1,336
1973	1,404
1974	1,762
1975	1,943

The decline in the level of returns examined since 1964 appears to reverse somewhat after reaching a low point in 1972. The number of examinations reported by the IRS in 1975, though an improvement, is but 60 per cent of the 1964 level. There is reason to expect another decline in 1977, when the impact of the IRS Commissioner's response to the President's interest in reducing government expenditures is felt. For fiscal 1977, the IRS requested $20 million less than the previous budget year and a reduction of 2,600 employee positions. Further, the IRS has predicted that these "cutbacks" will result in reducing the number of returns audited by 25,000.

A concern for this pattern was expressed by former Commissioner of Internal Revenue Randolph W. Thrower, while presenting the 1971-1972 appropriation request to the House Subcommittee on Appropriations:

> Continued success of the country's tax system depends on the ability of the compliance activities to detect and correct non-compliance, giving assurance to the taxpayer of equal treatment under the tax laws. There is no doubt that if, through successive years of inadequate enforcement manpower, the service should lose the ability to properly enforce the tax laws and to assure public confidence in equal treatment under those laws, it would have serious consequences for the nation, morally and economically. . . .
>
> In the long run, audit of returns is *the* guarantor of taxpayer compliance. The service has realized all along that by absorbing curtailments in the audit, it has been able only to postpone, not prevent, the weakening of public confidence in the fairness and thoroughness of tax administration. REPORT OF HEARINGS BEFORE A SUBCOMM. OF THE HOUSE COMM. ON APPROPRIATIONS, 92d Cong., 1st Sess. (Part 1) 529-48 (1971).

Existing Combined Enforcement Programs

With very few exceptions, state tax departments exchange information with the Internal Revenue Service on finalized audits. In this manner, both services maximize use of their audit personnel and eliminate unnecessary duplication. This exchange of audit data results in additional tax dollars at very low cost to both the Internal Revenue Service and the state tax department. One of the states (Wisconsin) submitted the following information from its records of audit data exchanged with the Internal Revenue Service.

Year	Period	State Abstracts Sent to IRS (Taxpayers)	Federal Abstracts Received by State (Taxpayers)
1966	7/1/65-6/30/66	10,900	9,900
1967	7/1/66-6/30/67	13,300	17,100
1968	7/1/67-6/30/68	13,900	19,400
1969	7/1/68-6/30/69	14,200	16,700
1970	7/1/69-6/30/70	13,800	12,100
1971	7/1/70-6/30/71	15,100	8,300
1972	7/1/71-6/30/72	15,300	6,500
1973	7/1/72-6/30/73	8,300	9,800
1974	7/1/73-6/30/74	8,500	12,100
1975	7/1/74-6/30/75	6,100	9,900
1976	7/1/75-6/30/76	5,600	8,500
TOTAL		125,000	130,300

The change in the trend that began in 1973 is the result of a new agreement with changed tax tolerances and accounts for different statutes of limitation and active audit periods. The Wisconsin abstracts, on the average, represent two audit years per taxpayer, while federal abstracts represent one audit year per taxpayer. Thus, expressed in taxpayer audit years, for some of the periods shown, the Wisconsin individual income tax effort was nearly twice that of the Internal Revenue Service. In other words, the total compliance effort in Wisconsin (state and federal) with respect to individual income tax was at least three times as great as it would have been if only the Internal Revenue Service had been enforcing Wisconsin's income tax laws. It is obvious that the self-assessment atmosphere was enhanced considerably during these years by the state enforcement efforts.

Public Law Number 92-512 does not provide for an increase in the enforcement level on the part of the Internal Revenue Service. The Service would not be able to maintain an adequate level of enforcement in those states where such activities are now sufficiently supported. If it is acknowledged that there is little duplication of effort between state and federal auditors, the Internal Revenue Service would have to increase its manpower to maintain present federal and state collection levels.

In the absence of an increase in manpower, federal assumption of the collection and administration of state individual income taxes would mean a decrease in the present combined level of enforcement. This would inevitably affect the taxpayer self-assessment system applicable to

both federal and state taxes. Consequently, with respect to revenue, only one result may be expected from participation in the federal collection system—a loss that will accumulate and multiply from year to year and be substantially in excess of the potential savings in administrative costs.

Of the 40 states in the 1977 survey, 9 of the 23 states that routinely provide state audit information to the IRS were able to provide estimates of additional collections made by IRS resulting from state audit information during 1976. These estimates were obtained from either district or regional IRS personnel or from estimates made by state administrators by recomputing federal taxable income and the resulting additional tax on audited return samples.

In these few states in which such information is readily obtainable, it can be demonstrated that the IRS profits from the state tax department audit activities. It is estimated that additional federal collections from state tax audit cases (in the nine states) amounted to $30 million in 1976. The combined enforcement costs (audit and collection but not processing) for the nine states was $29.4 million. The nine states' collections from audit and compliance activities exceeded $299.5 million. (Total additional collections were $299.5 million; $124.2 million resulted from office audit, $26.3 million from field audit, and $149 million from delinquent account collection activity. It is estimated that $55.7 million of total audit collections ($150.5 million) were attributable to completed audit data received from IRS; the remaining $94.8 million came from cases initiated by the state tax agencies.) Assuming this to be a typical year, under the federal collection system the IRS would lose $30 million and the nine states would lose $243.8 million in revenue. It would be logical to assume that these states would reject federal collection for the obvious revenue reasons. The federal government should be anxious to preserve these no- or low-cost sources of additional revenue. Public Law No. 92-512, a federal instrument, however, encourages states to abandon a system that is worthy of perpetuation and to eliminate a program that is beneficial to the federal government as well.

AN ALTERNATIVE TO THE FEDERAL COLLECTION SYSTEM

A number of states cannot participate in the federal collection system available under Title II, Public Law No. 92-512. For some, the precise shift to the federal tax base that is required for qualification would result in a loss of revenue dollars exceeding potential savings in administrative costs. Other states, especially those with effective enforcement

organizations, find their existing operations "profitable," with enforcement collections far exceeding the total costs of administering individual income taxes. Without some assurance that the IRS will increase their compliance capacities within their borders, these states will be unwilling to rely solely on federal administration. In another group are those states that either cannot participate at all for constitutional reasons or find that their options under Public Law Number 92-512 are limited, by constitution, to only one, perhaps the least desirable, method for taxing individuals under a qualified income tax. In other jurisdictions, certain high priority programs are closely linked to the income tax laws and, because of their purpose, have become almost politically immutable. It is questionable whether the permissible, separate administration of these functions, while the IRS assumes control of the income tax laws, would be an advancement in the management of the states' affairs or allow optimum reduction in agency expenditures.

For some states, however, participation in federal collection may be sought. Whatever the number of states in this category, should they choose to adopt federal collection, the combined costs to the Treasury would be borne by the taxpayers of all the states. This constitutes an unfair distribution of benefits for all remaining states, including those that cannot qualify (because of constitution prohibitions) or wish not to do so (because of revenue losses). Public Law Number 92-512 does not provide an acceptable alternative to this group.

It is recommended that the best way to encourage states to rely more completely on their own resources and to give the individual income tax the kind of administrative attention it should receive is to find ways to strengthen existing audit and collection functions. As observed earlier in the review of data taken from the surveys (see pages 491-94) and in the discussion of IRS benefits from state audit information exchange (see pages 496-98), a continuation of the activity levels in strong enforcement states will reward those states, as well as the federal government.

To help support the effective programs now present in some states, to help other states to improve their existing capabilities, and to give all states that do not wish to participate in federal collection under Public Law Number 92-512 an alternative benefit, it is recommended that legislation be introduced that will provide federal cost sharing of state individual income tax audit and collection programs. Under this proposal, a state may qualify for reimbursement, not to exceed 50 per cent of direct enforcement costs, if: (1) it meets performance and staffing standards established by the Treasury; (2) its training and other qualification standards for employment are at least equal to those for com-

parable IRS positions; and (3) it agrees to reciprocally share its audit and compliance data with the IRS.

This recommendation is advanced as an aid available to all states. Its costs would be small compared with the total amounts spent for federal and state individual income tax collections, and the potential for shared gains resulting from improved revenue administration would far exceed suggested expenditures.

SUMMARY

The Revenue Sharing Act of 1972 provides an optional arrangement for the federal collection of state income taxes. In order for the federal government to assume this function, the states entering into this agreement must conform their income taxes generally to the federal income tax.

Advocates of federal collection urge that this piggyback system will eliminate duplication of administrative efforts; simplify the job of preparing tax returns for taxpayers; speed up the flow of income tax revenue into state treasuries because of the federal withholding system expediting the deposit of withheld taxes; and reduce the administrative costs of the participating states while benefiting from the efficiencies of IRS, since the federal collection system is considerably more effective than that of the states.

It is likely that federal collection will eliminate much of the duplication of administrative effort as far as routine processing operations are concerned—those operations involved with receipt and processing of returns. This will not be true, however, in respect to compliance enforcement activities, where, at present, *combined* federal and state efforts cover only a relatively small percentage of all individual income taxpayers. Admittedly, federal collections may speed up cash flows from withheld taxes in most states. The amount of the speedup, however, will vary from state to state. A substantial, although not equivalent, speedup can be achieved in many states by changes in state laws.

Since most states already use federal adjusted gross income or taxable income as the starting point in computing taxable income for state purposes, the extent to which the filing process is simplified is probably rather modest for those taxpayers filing in only one state. For a nonresident filing in two or more states electing federal collection, the computation of taxable income should be simpler than it is at present. On the other hand, if a nonresident files in a combination of electing and nonelecting states, his situation may not be very different from

that presently prevailing. All in all, simplification in filing requirements may be achieved for some taxpayers under the federal collection approach, but, at best, the improvements expected must be characterized as modest.

States that enter into a collection agreement expose their tax structures to changes in the federal system. On occasion, these can lead to unanticipated losses that are difficult to recoup. Beyond its influence on revenue, piggybacking commits a state to United States tax policy and leaves little or no chance for modification of the approved tax base.

Consenting states will have two choices in fixing their tax rates: (1) to impose a state tax as a percentage of federal tax or (2) to impose a single rate or a series of graduated rates of tax against federal taxable income, modified as required by federal law. Under either system, certain adjustments are required to arrive at state tax liability, while others are optional. The ability to allow special tax credits to be taken against the income tax will be substantially restricted. For example, a property tax relief credit against income tax based upon an age and means test and special credits for contributions to educational institutions are not allowed as part of a qualified income tax.

Under existing state constitutions, some states either cannot elect federal collection of their individual income taxes or must restrict their choice to one of the two alternative methods of taxation permissible. Further, the right to base state tax liability on provisions of a federal law that may be changed after adoption of a state statute is open to doubt in a number of states.

Total federal tax collections are about eight times greater than total state individual income tax collections, but the IRS's efficiency factor, based on costs per $100 of tax collected, appears to be only three times better than that of the states. Since collection costs are relatively fixed per number of taxpayers, it is believed that the reason the IRS appears to be more efficient in terms of costs per $100 collected is because the United States tax burden on individuals is about eight times larger than that of the states taken collectively.

Both the 1970 and 1977 surveys of the states show that their productivity was comparable to that of the IRS. Combined totals for the states show that additional collections from enforcement activities far exceeded the direct enforcement cost.

With few exceptions, state tax departments exchange information with the Internal Revenue Service on finalized audits. In this manner, both services maximize the use of their audit personnel and eliminate

unnecessary duplication. In the absence of increased manpower for the Internal Revenue Service (which was not provided by Public Law Number 92-512), federal assumption of the collection and administration of state individual income taxes will mean a decrease in the present combined level of enforcement. This will inevitably affect the taxpayer self-assessment system for both federal and state taxes.

A number of states cannot or will not participate in federal collection for either revenue, constitutional, political, or other reasons. For those states electing to piggyback, however, the combined administrative costs to the Treasury on their behalf will be borne by the taxpayers in all states. This constitutes an unfair distribution of benefits and provides no alternative for nonelecting states.

As an alternative, it is recommended that federal cost sharing of state individual tax audit and collection programs be offered to those states meeting performance and staffing standards. Reimbursement of the direct enforcement costs of the states will add to the potential for shared gains and will thereby benefit the states as well as the federal government.

Q

Piggybacking and Conformity: Some Technical Problems

Dale S. Collinson

Federal collection of state individual income taxes (piggybacking) is an appealing concept. It would greatly simplify the preparation of tax returns by permitting taxpayers to complete a single return for both federal and state income taxes, with a supplemental state income tax schedule showing the state adjustments to the federal tax base. Because of the opposition of state tax administrators and a justifiable reluctance by the state governments to link a state's fiscal destiny and tax policy to the federal tax system, however, it is unlikely that any state will adopt piggybacking.

Many of the benefits of piggybacking in terms of simplifying tax return preparation may be obtained by conforming the state income tax to the federal, but it is essential to minimize the number of variations from the federal tax base. Some of the problems that must be resolved in a conformity statute can be illustrated by examining some technical problems in the present piggybacking statute, Sections 6361-6365 of the Internal Revenue Code.

The piggybacking statute defines two forms of state income taxes that qualify for federal collection: the federal income base alternative and the percentage-of-federal-tax method. Under the federal income base alternative, the state tax is determined by applying the state tax rate schedule to the taxpayer's federal taxable income, as modified by certain required and permitted adjustments. Under the percentage-of-federal-tax method, the state tax is a fixed percentage of the taxpayer's federal tax liability, as modified by certain required and permitted adjustments. State conformity statutes include the percentage-of-federal-tax form and state income taxes that base state income on either federal taxable income or federal adjusted gross income.

* Dale S. Collinson is a member of Willkie, Farr & Gallagher, New York, New York.

TREATMENT OF FEDERAL TAX CREDITS

An increasingly prevalent feature of the federal tax system is the use of tax credits rather than deductions. Examples include the house purchase credit, the child care credit, and the earned income credit. A percentage-of-federal-tax conformity or piggybacking statute automatically adjusts to general tax credits, but a statute based on federal income does not. Thus the conversion of the child care deduction to a tax credit could increase state taxes in a state with the latter form of statute, unless the state statute were amended to provide a parallel state credit (with rates and limitations appropriate to the state rate structure). Of course, there would be legislative difficulties in amending the state statute each time a federal tax credit was enacted or amended; and a profusion of state credits would obviously increase complexity.

This problem could be solved by providing a state tax credit equal to a fixed percentage-of-federal-tax credit (not including the withholding tax credit or the foreign tax credit). Such a credit is not permissible under the present piggybacking definition of a qualified state income tax based on federal taxable income; credits paralleling federal credits are also not permissible.

FISCAL IMPACT

A major concern of the states with respect to piggybacking has been that federal tax changes may substantially affect state revenues and, thus, cause a budget crisis. For example, there have been four federal tax cuts in the last three years (Tax Reduction Act of 1975, Revenue Adjustment Act of 1975, Tax Reform Act of 1976, and Tax Reduction and Simplification Act of 1977). Under a percentage-of-federal-tax piggybacking or conformity statute, each of the federal tax cuts would reduce state revenues [1] unless the state adopted an offsetting rate change. The piggybacking provisions, however, provide that a state may not enact a change for a calendar year after November 1 of that year. Often, a state would not have time to enact the necessary legislation by that date. Also if states enact offsetting legislation each time there are substantial changes in the federal income tax, either there will be a delay in the publication of federal withholding changes until the state changes are made or businesses will have to implement two changes.

[1] To the extent these acts merely continued earlier tax cuts, the "reduction" in state revenues might also be characterized as the avoidance of an "increase" that would have occurred had the prior tax cuts not been continued. In either case, the state's revenues were uncertain.

If the President's proposal to convert the $750 personal exemption deduction and the general tax credit to a $240 personal exemption tax credit is enacted, the fiscal impact problem can be minimized by basing the state statute on federal taxable income. The main techniques for cutting or increasing federal taxes are tax surcharges, and changes in the rates, personal exemption, and standard deductions. The standard deduction is now built into the rate changes, and if the personal exemption were a credit rather than a deduction, none of those changes would affect federal taxable income. This, of course, assumes that the state would have its own personal exemption credit or deduction and would exclude the federal credit from the base of the percentage-of-federal-credits credit recommended above.

Another possibility is to authorize the governor to make a flat percentage change in rates as needed to offset federal tax changes.

PERMITTED ADJUSTMENTS

It is inevitable that any state conformity or piggybacking statute will depart from the federal statute in some respects. For example, state taxes deducted on the federal return are generally restored to state taxable income. Under the piggybacking statute, the permitted adjustments have been severely limited. This simplifies the tax return for taxpayers and reduces the potential administrative burden for the Internal Revenue Service. The adjustments are somewhat different for the qualified federal taxable income statute and the qualified percentage-of-federal-tax statute, but we need examine only the former in order to discern the general approach. Under the qualified federal taxable income statute, a taxpayer would be required to adjust federal taxable income by (1) subtracting interest on federal obligations, (2) adding the net state income tax deduction (that is, adjusted for state income tax refunds), and (3) adding net tax-exempt income (that is, adjusted for disallowed interest expense). In addition, the state could elect (1) to impose a minimum tax (that is, a tax on the amount taxed under Section 56), (2) to allow a credit for taxes imposed by another state or its political subdivisions, and (3) to allow a credit for all or part of its general sales tax. A politically acceptable piggybacking or conformity statute would probably also permit a number of other adjustments, including the following:

(1) A credit for state property taxes, which would allow state "circuit-breaker" credits to be administered through the income tax system rather than as a separate grant program

(2) A general credit equal to a fixed percentage of federal credits, as discussed above

(3) A separate personal exemption deduction or credit, assuming the federal exemption is converted to a credit

(4) A transitional rule exempting from capital gains tax appreciation accrued before the effective date of the original state income tax law. (See *Thorpe v. Mahin*, 250 N.E.2d 633 (Sup. Ct. Ill. 1969) suggesting such a transitional rule may be constitutionally required.)

OTHER TECHNICAL QUESTIONS

Any conformity or piggybacking statute must also deal with a host of other issues that require careful consideration, although they do not detract from the pressing need for conformity. These include rules respecting the treatment of net operating losses and the availability of averaging, given the potential differences in federal and state taxable income, and rules defining tax jurisdiction, such as residency tests for individuals and trusts.

R

Federal Income Tax Simplification: The Political Process

Paul R. McDaniel

INTRODUCTION

Any writer with a sense of history and a proper respect for the efforts of tax scholars, practitioners, and officials over the past six decades must approach the subject of tax simplification with considerable humility. A review of the literature quickly reveals that the foremost tax authorities our country has produced have addressed themselves to the issue of simplification. And for over 60 years, these commentators—both in and out of government—have identified with striking uniformity (1) the different meanings that can be assigned to the phrase "tax simplification"; (2) the causes of tax complexity; and (3) the high probability that we will not achieve substantial "simplification," however defined, in our federal income tax system. Some indeed have concluded that the objective does not deserve the prominence that has been accorded it in the current discussions of tax policy issues.[1]

* Paul R. McDaniel is a Professor of Law at Boston College Law School, Newton, Massachusetts.

[1] *See* Bittker, *Tax Reform and Tax Simplification,* 29 U. MIAMI L. REV. 1 (1974); Blum, *Simplification of the Federal Income Tax Law,* 10 TAX L. REV. 239 (1954); Eichholz, *Should the Federal Income Tax Be Simplified?* 48 YALE L.J. 1200 (1939); Eustice, *Tax Complexity and the Tax Practitioner,* 8 TAX ADVISOR 27 (1977); Ginsburg, *Tax Simplification—A Practitioner's View,* 26 NAT'L TAX. J. 317 (1973); NTA-TIA Symposium, *Tax and Budget Simplification,* 30 NAT'L TAX. J. 223 *ff.* (1977); Paul, *Taxation in the United States,* 379-92 (1954); Paul, *Simplification of Federal Tax Laws,* 29 CORNELL L.Q. 285 (1944); Roberts, Friedman, Ginsburg, Louthan, Lubick, Young, and Zeitlin, *A Report on Complexity and the Income Tax,* 27 TAX L. REV. 325 (1972); Surrey, *The Federal Tax Legislative Process,* 31 REC. A.B. CITY N.Y. 515 (1976); Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail,* 34 LAW & CONTEMP. PROB. 673 (1969); Surrey & Brannon, *Simplification and Equity as Goals of Tax Policy,* 9 WM. & MARY L. REV. 915 (1968); Woodworth, *Tax Simplification and the Tax Reform Act of 1969,* 34 LAW & CONTEMP. PROB. 711 (1969); Remarks of Edwin S. Cohen, *reprinted in* 26 NAT'L TAX. J. 311 (1973); Remarks by the Hon. Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, Before the American Bar Association National Institute

The length of time that the tax simplicity-tax complexity discussion has covered is highlighted by the fact that the 1977 study by the Staff of the Joint Committee on Taxation, *Issues in Simplification of the Income Tax Laws*,[2] appeared exactly 50 years after the first comprehensive report on tax simplification was issued by the Joint Committee on Internal Revenue Taxation in 1927. And that report was in response to a rising crescendo of complaints about complexity of the income tax laws that apparently began as early as 1918.[3]

Fortunately, to a considerable extent, the topic assigned for discussion in this paper permits us to avoid covering once again ground that has been surveyed by many able observers. The focus herein is on the process that produces the body of tax legislation that is the source of tax complexity, however defined. Certainly, prior commentators have observed in a general way that one source of our complex income tax laws is the nature of the political process in which tax legislation is forged.[4] And the tax legislative process itself has been described in some detail.[5]

It is appropriate, however, to examine more closely the politics of tax legislation by identifying as precisely as possible the forces and factors operative in the tax legislative process, with the specific objective of assessing whether their presence and method of operation tend to move the system toward complexity or toward simplicity. This inquiry is especially timely, since the tax legislative process is, at present, in a transition period. Elements in the process have appeared in the past decade that were not previously present; other traditional elements have shifted in importance; and new legislative techniques are emerging that have the potential for substantially modifying the tax legislative process. It is useful to examine these changes and to attempt a preliminary assessment concerning whether more or less tax complexity will result from their implementation.

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on Tax Reform, *reprinted in* 23 Tax Law. 417 (1970); Address by Jerome Kurtz, Commissioner of Internal Revenue, Before the Eleventh General Assembly of the Inter-American Center for Tax Administrators, Tax Simplification: Some Observations from a Retrospective View of the United States Experience, *reprinted in* 123 Cong. Rec. S. 8349 (daily ed. May 23, 1977); Nolan, *A New Tax Structure for the United States—Problems of Implementation and the Impact of the Political Process* (Univ. of Mich. Key Issues Lecture Series, Mar. 30, 1977). *See also* U.S. Treas. Dep't, House Ways and Means Comm. & Senate Finance Comm., 91st Cong., 1st Sess. 73 (Comm. Print 1969).

[2] Committee Print, 95th Cong., 1st Sess. (Sept. 19, 1977).

[3] *See* Paul, *supra* note 1, at 387; Eichholz, *supra* note 1, at 1212.

[4] The point is made by several of the authors cited in note 1.

[5] *See* J. Pechman, Federal Tax Policy, 32-53 (3d ed. 1977); 1 S. Surrey, W. Warren, P. McDaniel, & H. Ault, Federal Income Taxation 50-53 (1972); *Id.* at 34 (1977 Supp.); Graetz, *Reflection on the Tax Legislative Process: Prelude to Reform*, 58 Va. L. Rev. 1389 (1972); Surrey, *Reflections on the Tax Reform Act of 1976*, 25 Clev. St. L. Rev. 303 (1976).

Because the focus of this analysis is on the process by which the tax statute evolves, no attempt is made to confine simplification to any of the various meanings that have been assigned to it. Whether by "simplification" one means more easily understood statutory language, increased ease or efficiency of tax administration, greater certainty in planning, more understandable forms, or more coherent resolution of tax issues by the courts, the fact is that all of these concerns derive fundamentally from the tax statute itself. The following analysis of the tax legislative process therefore attempts to identify the extent to which the forces operating within the process tend to affect "simplicity" in one or more of the above senses. Moreover, because we are examining a process, attention will be given to whether the tax legislative process *qua* process is moving toward simplification or complexity.

WORKING HYPOTHESES

As a means of orienting the descriptive material that follows, two working hypotheses will be employed.

(1) In terms of the simplification-complexity issue, particular tax provisions—existing or proposed—may be classified as "structural" or as "tax expenditures."

In the "structural" category fall those provisions necessary to implement a tax on net income. These provisions must be applied to complex situations, such as corporate-shareholder relationships, accumulation trusts, transactions across international borders (especially by a related group of corporations), intricate financial transactions involving the capital structures of large corporations, partnership tax shelter transactions, and the like. In these situations, the underlying transactions to which the tax laws must be applied are characterized by extraordinary complexity; effective application of the income tax in these contexts inevitably requires complex statutory formulations.[6] Acceptance of complexity in this category should not, however, imply acceptance of a lack of logical and structural coherence in the statutory response.

In the second category are the "tax expenditure" provisions that so dominate the Internal Revenue Code. These provisions are not required to implement a tax on net income; thus they add complexity to the Code. If the tax route is followed to provide financial incentives or relief, however, complexity in the Code is unavoidable.[7] Closely

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[6] *See, e.g.,* Cohen, *supra* note 1, at 424; Bittker, *supra* note 1, at 2-3.

[7] *See, e.g.,* Eustice, *supra* note 1, at 29; Kurtz, *supra* note 1; Nolan, *supra* note 1, at 2, 17; Surrey, *supra* note 1, at 683. *See also* Altman, *A Simplification of the Income Tax,* 22 TAXES 146, 185 (1944) "[T]he [tax] law will never be simple as long as it is a mass of special allowances and special privileges."

related to the tax expenditure provisions are those private relief bills for particular taxpayers that masquerade as provisions of general application.[8]

The first working hypothesis is that tax simplification has quite a different meaning when one is considering provisions in the "structural" category than when a "tax expenditure" is involved. The criteria for, and the objectives to be achieved by, tax simplification are distinct and not generally interchangeable.

(2) A separate question involves the process by which a tax provision is considered, regardless of its classification. Even if a provision is unavoidably complex, it nonetheless remains to be determined whether the process by which that provision is considered is itself unacceptably complex. Complexity in the context of the process by which legislation is considered refers to whether the different categories of tax provisions listed above are dealt with in a rational manner by Congress and the executive branch.

In this respect, there has been a gap in the dialogue between critics outside government and those whose daily professional efforts are conducted within the tax legislative process. On the one hand, the message of outside critics implicitly seems to be: "The tax system is too complex; we have identified the causes of complexity; now change things." This message has an air of unreality to those in government who must work within the existing political framework. "How," they ask, "do you expect to accomplish simplification given the present political realities of the system?" Both positions have merit. It is unrealistic to call for tax simplification without recognizing that the goal must be achieved through the political process, which itself may be part of the problem, and without identifying the existence, strength, and interests of the various factors operating within the process. On the other hand, the too frequent claim of governmental officials that "it can't be done politically" cannot be allowed to bring simplification efforts to a halt. This paper is an attempt to bridge the gap by examining how the goals of simplification may or may not be expected to be achieved within the political process.

This examination, undertaken within the complexity-simplicity framework suggested above, leads to the second working hypothesis: The political strategies required to achieve simplification differ depending on the type of tax provision under consideration. Somewhat paradoxically, analysis of the tax legislative process reveals that we appear to be moving toward a more rational method for handling those provisions

[8] *See* Roberts, *et al.*, *supra*, note 1, at 337.

that produce the greatest and least necessary complexity in the tax laws—tax expenditures. Less progress is discernible, however, toward providing a more rational mechanism for dealing with those structural provisions in which complexity is neither undesirable nor avoidable.

We now turn to a description of the factors that influence tax legislation. It is hoped that this description will enable us to test the validity of the working hypotheses and to suggest practical modifications in the tax legislative process that can produce greater simplicity where complexity is unnecessary and greater coherence where complexity is necessary. To achieve this objective, the following materials do not trace the course of tax legislation in a chronological order. Rather, the technique is to identify the factors in terms of their practical political effect on tax legislation. This method of analysis is necessary to develop a strategy to achieve tax simplification, since dealing successfully with a particular factor may involve identifying its importance long before it surfaces publicly in the tax legislative process.

FACTORS AFFECTING TAX LEGISLATION

In this section, the factors—institutional and external—that influence tax legislation are identified and analyzed in terms of their contribution to complexity in the tax law. It must be recognized that any listing imposes an order and stasis that is not, in fact, present in the political milieu in which tax legislation is considered. One crucial variant is the changing cast of characters who are, from time to time, responsible for executing the duties or responsibilities of a particular office or position. As the interests, powers, and abilities of the people who fill the different positions change, so, too, does the influence or importance of a particular factor in the equation. For example, the weakened influence of one office or position invites or provides an opportunity for stronger action by another. Changing economic issues, such as unemployment, energy shortages, and national security, bring to the forefront of the tax legislative process elements that previously may have played less significant roles. Although, with hindsight, one can recognize the shifts, predicting them in advance is much more difficult. With this important caveat, identification of the factors and the roles they have played in the past (and appear to be playing presently) can help us to form judgments of the role each ought to play in the tax legislative process if we seek to eliminate unnecessary complexity and to make the necessary complexity more coherent.

Factors Operative in the Executive Branch

The Treasury. The Treasury, of course, plays the leading role in the executive branch participation in the tax legislative process. That role, however, has many facets. Primarily through the Office of the Assistant Secretary for Tax Policy, the Treasury ideally must (1) perform the necessary research and analysis to develop particular tax legislative proposals; (2) assist in the creation of a political climate that is receptive to the proposals; (3) serve as the focal point for resolving the interests of outside lobbying, Congressional pressure, and interdepartmental interests; (4) provide the political and technical resources and expertise to move the proposals through the legislative process by defending the Administration's own proposals and responding to Congressional initiatives; and (5) institute long range studies to identify structural deficiencies, develop the necessary revisions, and review and evaluate existing provisions.

To carry out successfully all these legislative responsibilities, a sizeable, highly competent (both in terms of technical tax expertise and political judgment), and carefully administered Treasury staff, with a developed and consistent view of tax policy issues, is obviously required. As noted, changing personnel inevitably will perform more or less well in the different aspects of the Treasury's legislative role. Failure on the part of the Treasury staff to competently execute its multiple responsibilities will, however, help produce a tax statute that is less than optimal within the simplicity-complexity framework outlined in the preceding section.

Experience over the past decade has highlighted some critical stress points in the Treasury's tax legislative operation. To some extent these stresses are imposed from without, and to some extent they are self-generated.

The most important development has been the rapid expansion in tax expenditures that has occurred over the past 10 years. When the first tax expenditure list was published in 1968, it numbered 50 items involving total revenues of somewhat over \$44 billion. As of January 1, 1977, that tax expenditure list included 86 separate items, totaling over \$114 billion.[9] Legislative responsibility for these government spending programs all devolved on the tax policy office in the Treasury.

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[9] The growth of tax expenditures may be seen by comparing the tax expenditure budgets for 1968 through 1978, as set forth in I. S. Surrey, *et al.*, *supra* note 5, at 242-45; *id.* at 101-105 (1975 Supp.); *id.* at 123-26 (1977 Supp.). The discussion in this paper assumes that the reader is familiar with the tax expenditure concept. *See* S. SURREY, PATHWAYS TO TAX REFORM (1973), for a comprehensive discussion of the concept.

A 72 per cent increase in the number of programs and a 260 per cent increase in revenues involved would have seemed to require both a substantial increase in the Treasury tax policy office staff and a restructuring of its method of operation. But the legal staff in the Office of Tax Legislative Counsel in 1977 was nearly the same size (about 17 lawyers responsible for domestic tax legislation and 6 for international tax matters) as it was in 1968. Likewise, the staff of the Office of Tax Analysis (some 40 professionals, including about 30 economists) has not grown appreciably over the past 10 years. Nor has either office been reorganized to any significant extent.

Not surprisingly, the Treasury staff must now devote a major part of its legislative attention to the existing and expanding list of tax expenditure provisions, analyzing their impact on the distribution of tax burdens, their benefits compared to cost, and so forth. In the 1971-1976 period, the Treasury was also called upon to develop new tax expenditures (for example, DISC, ADR) or to defend existing ones (for example, deductions for percentage depletion, intangible drilling, and development costs).

As one result, the small Treasury legal staff inevitably has not been able to devote itself to the thoughtful and reflective research and analysis necessary to implement coherent structural responses to some areas that are in need of attention, such as a number of points within subchapter C, the grantor and accumulation trust rules, the partnership provisions, and the foreign tax credit rules (which are teetering on the brink of conceptual chaos as the result of recent legislative actions). In these areas, as has been observed, achieving rational coherence, not total elimination of complexity, is the goal. Failure by the Treasury to give legislative attention to these issues continues unnecessary and avoidable complexity in the income tax system.

The rapid expansion of tax expenditures has produced another result in the complexity-simplicity context. The decision to utilize the tax system as the mechanism for providing federal financial aid automatically places these programs within the Treasury. The Treasury legal staff is composed, however, of tax lawyers trained to think in terms of tax concepts. Understandably, in developing legislation to implement tax expenditures, these lawyers apply tax concepts to the drafting and development of the spending programs. But tax concepts that originated in the context of applying structural tax provisions to personal and commercial transactions frequently have little relevance to the development of properly structured spending programs.

Thus, for example, the maximum allowable investment credit was

set at 50 per cent of tax liability.[10] That is a familiar tax technique to prevent tax provisions from producing zero tax liability or to control revenue costs of such provisions. But it makes no sense at all in a spending program. What Secretary of Commerce would ever suggest, or even think of, limiting a direct subsidy for machinery and equipment to a percentage of the recipient's tax liability to the Treasury Department? Moreover, developers of tax legislation in the Treasury Department have almost inevitably been led to the view that some tax liability is essential to qualify for the credit.[11] The public concern over high-income individuals who pay little or no tax reinforces this view. But again, the existence or lack of tax liability to the Treasury is utterly irrelevant to direct subsidy programs developed in other departments.

From a spending standpoint, the illogical limitation on the investment credit then led advisers of loss companies (or companies up against the 50 per cent limit) to develop complex schemes to avoid the limitations. The equipment-leasing tax shelter transactions resulted. This, in turn, led tax reformers to introduce additional tax responses, namely, the minimum tax, the general prohibition on the use of the credit by individual investor-lessors, and the at-risk rules.[12] Thus an additional layer of complexity was added to the tax system.

As another example, it is well recognized that the tax system can be employed to provide interest-free loans to selected industries or activities. When the decision is made to provide loan assistance through the tax system, tax technicians normally think in terms of provisions to accelerate deductions. The interest-free aspect flows automatically because the loan program is placed in the tax computation. Interest-free loans, however, are not normally employed in direct loan programs. One could introduce an interest charge into the "tax loan" programs by, for example, requiring the taxpayer to pay a specified interest rate to the Treasury each year on the tax saving produced by the accelerated deductions claimed by the taxpayer. But such an interest charge is a strange concept to a lawyer trained in tax principles, although his drafting counterpart in another department would be equally surprised by a loan program that was interest-free (and unsecured, increasing in amount as a function of the tax rate, and so forth).

As in the case of the investment credit, accelerated deductions, once introduced, led to tax shelter transactions to enable otherwise ineligible

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[10] I.R.C. § 46(a)(3)(C).

[11] Carryovers and carrybacks of excess credits are allowed. I.R.C. § 46(b). The requirement of tax liability generally excludes all tax-exempt organizations from the investment tax credit.

[12] I.R.C. §§ 57(a)(3), 46(e)(3), 465(c)(1)(C).

businesses (those without otherwise taxable income) to take advantage of the tax loans. Tax officials then grew concerned over the impact on tax equity and introduced countermeasures that make sense from a tax standpoint but usually render the expenditure programs even more irrational as spending programs, for example, limitations on investment interest, maximum tax limitations, and at-risk rules.[13]

Thus the use of tax expenditures has produced a double level of complexity in the tax laws: first, when the provision is introduced and, second, when tax reformers seek to limit the adverse effects of the special tax provisions on tax equity. The net result of this process has been a tax system that spirals toward ever-increasing complexity and financial assistance programs that are often irrational and sometimes counterproductive when evaluated under direct spending program criteria.

The $114 billion of tax expenditures in fiscal year 1977 accounted for some 25 per cent of total federal spending for that year. This fact dictates that the Treasury contribution to greater simplicity through long range studies must focus on the tax expenditure provisions. It is not enough to assert that the existing tax expenditures are detrimental to the causes of tax equity and tax simplicity. Supporters of tax expenditures are willing to concede these points, but the political debate and pressures then focus on the purposes for which federal tax spending is sought. Treasury studies that have as their objective tax simplification must therefore determine whether the tax expenditure programs are efficient, effective, and equitable programs that achieve the avowed purpose of each and, if a program is needed, whether the program should be run through the tax system or directly.

The sheer size and number of existing tax expenditures, in addition to the power of their constituencies, really permit no other approach by the Treasury. These facts of political life were what gave such an otherworldly quality to the Treasury's 1977 *Blueprints for Basic Tax Reform*. Although one could not generally quarrel with these blueprints for a more comprehensive income tax base, it strained credulity that the Treasury seriously believed that 25 per cent of the federal budget could be repealed to achieve greater tax equity and tax simplicity. No beneficiary of a direct government program, after all, is likely to acquiesce in the repeal of that program in return for a general tax rate reduction!

A much more sophisticated approach is required. Thus comprehen-

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[13] *Id.* §§ 163(d), 1348(b)(2), 465(c)(1).

One should note that the text description of the irrationality in spending terms of the tax expenditures is based on analytic tools that were not available to tax technicians when the provisions were first introduced. Tax technicians presently responsible for tax policy, however, do have the necessary conceptual framework for analysis.

sive studies of some tax expenditures would indicate that total repeal is proper (the 1977 Treasury study on DISC[14] is an example of the requisite analytical approach, which revealed the lack of a need for any federal subsidy at all). But in many other areas where tax expenditures are involved, a more carefully targeted response than general rate reductions is required. In some cases, the studies might reveal the desirability of transferring tax expenditure funds to existing or newly created direct programs.[15] In other instances, the tax expenditure route might continue to be employed but with a revised tax program to produce a more rational, efficient, and equitable spending program.[16]

In sum, the Treasury Department, as the focal point of tax legislative activity for the executive branch, plays a crucial role in the simplicity-complexity issue. But changes in Treasury operations, notably in the Office of the Assistant Secretary for Tax Policy, are required if it is to be an effective force in the simplification effort. These changes include:

(1) Enlargement of the tax policy staff

(2) Administrative reorganization of the staff operations to permit longer range consideration of structural areas where greater simplicity can be achieved through more rational and coherent tax provisions. (As a corollary, the Treasury should encourage and support those groups outside government that possess the capability for systematic research and analysis (for example, the American Law Institute) and integrate their work into its own.)

(3) Implementation of systematic studies of tax expenditures to determine if they can be repealed, shifted to direct programs, or structured to produce the optimal spending program. In this context, traditional "tax thinking" only produces greater complexity; somewhat ironically, "spending thinking" is required to achieve tax simplicity.

Other Departments. Another trend discernible in the past decade is the increasing involvement in the tax legislative process of executive branch departments other than the Treasury. These departments are to be found as political factors in the tax process because of the existence of tax expenditures.

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[14] 1977 U.S. TREAS. DEP'T ANN. REP., THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1975 ANN. REP. (1977) [hereinafter cited as the DISC REPORT].

[15] One would anticipate this result, for example, in the case of tax expenditures for low-income housing, medical care, home ownership, and charitable contributions.

[16] Senator Kennedy's proposals to make the investment credit incremental and refundable appear to proceed on this premise. *See* 123 CONG. REC. S. 11408, 11413-14 (daily ed. July 1, 1977).

The participation of nontax departments of the executive branch pulls both ways along the complexity-simplicity continuum. On the one hand, given the presence of tax expenditures, the nontax departments potentially can be forces for simplification of the tax laws, as for example, by opposing proposed tax expenditures in their area of expertise on programmatic grounds or by making existing tax expenditures more rational, efficient, and equitable as spending programs. On the other hand, the mere presence of these additional forces complicates the political process, since more interests have to be reconciled. Moreover, some nontax departments are, in part, responsible for introducing new, or urging continuation of a number of existing, tax expenditures. In this respect, they contribute to unnecessary complexity in the tax system. In the latter instances, the departments involved have appeared unwilling or unable to evaluate the tax expenditures by applying the criteria they routinely employ to evaluate spending programs for which they have direct responsibility. The problem here is the reverse of that at the Treasury: The nontax departmental staffs must become more proficient in and habituated to translating spending programs drafted in tax terminology into corresponding direct spending programs so that they may then apply the appropriate criteria.

The records of the different departments are mixed. The Department of Health, Education, and Welfare has, at times, demonstrated a clear understanding of the relationship between tax and direct expenditures for health, education, and welfare. For example, in 1977, it opposed tax credits for education costs, based on the incompatibility of the educational policies underlying the tax credit programs with those undergirding direct programs for financing education.[17] Some agricultural economists in the Department of Agriculture have exposed the inconsistencies of existing tax expenditure programs for agriculture with the nation's overall agricultural policies,[18] and their analyses appear to be having an effect on departmental positions. The Department of Housing and Urban Development has a mixed record: It was responsible for the introduction in 1969 of the roll-over provision in Section 1039 for investments in low-income housing; its adverse study in 1975 helped

[17] *See* letter from HEW Secretary Joseph Califano to Senator Kennedy (March 31, 1977), *reprinted in* 123 CONG. REC. S. 5303 (daily ed. Mar. 31, 1977).

[18] *See, e.g.*, W. Woods, Property and Estate Taxes—Their Potential for Affecting Land Allocation Decisions (paper presented at the Workshop on Land Use Planning in Rural Areas, Raleigh, N.C., Nov. 16, 1976); HARRISON, ACCOUNTING METHODS ALLOWED FARMERS: TAX INCENTIVES AND CONSEQUENCES (U.S. Dep't of Agriculture, Economic Research Service Pamphlet No. 505, 1973); HARRISON & WOODS, FARM AND NON-FARM INVESTMENTS IN COMMERCIAL BEEF BREEDING HERDS: INCENTIVES AND CONSEQUENCES OF THE TAX LAW (U.S. Dep't of Agriculture, Economic Research Service Pamphlet No. 497, 1972).

repeal the ill-considered tax credit for new residence purchases; [19] but its continued opposition to the repeal of tax preferences for low-income housing stands as a major obstacle to cutting back tax preferences for real estate generally. The Department of the Interior historically has been a forceful lobbyist for tax expenditures for the natural resource industries. The Department of Commerce has, by and large, also been an advocate of tax expenditures for business, circulating suspect studies to support DISC, supporting an expanded investment credit for the shipping industry,[20] and so forth.

The presence of nontax departments as a political force in the consideration of tax legislation thus produces mixed results in terms of tax simplification. These departments are a complicating factor by their mere presence in the process. Moreover, it must be recognized that, in general, a nontax department will oppose a tax expenditure only if it believes it can obtain the requisite funds for a comparable program in its own budget. If its appropriations are at their upper limit, the nontax agency will almost inevitably favor a tax expenditure—any tax expenditure—that might make its own direct programs more attractive. But if tax expenditures are to continue to be utilized, the presence of nontax departments in some form is essential if the tax-spending programs are to be rational and effective. We return below to the question of whether the expertise of these departments can be more effectively utilized in the cause of tax simplification.

Office of Management and Budget. The Office of Management and Budget (OMB) is generally associated with the formulation and implementation of the direct budget. It is, perhaps, less well known that OMB plays an increasingly important role in the tax legislative process.

This role became formalized with passage of the Congressional Budget Act of 1974.[21] That Act required the preparation of a tax expenditure budget to be submitted each year with the President's direct budget recommendations.[22] The tax expenditure lists have been included in the 1976, 1977, and 1978 budgets as Special Analysis F. The OMB has made some preliminary, but not really adequate, attempts to correlate tax and direct spending budget figures that relate to the same budget area.[23]

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[19] *Reprinted in* 121 Cong. Rec. S. 22174-75 (daily ed. Dec. 15, 1975).

[20] *See* Tax Analysts & Advocates, 3 Tax Notes No. 30, at 22 (July 28, 1975).

[21] Pub. L. No. 93-344, 88 Stat. 297 (1974) [hereafter cited as "Budget Act"].

[22] *Id.* § 601.

[23] *See, e.g.*, Office of Management & Budget, Budget Special Analyses for Federal Social Programs (1978).

The responsibility of OMB with respect to tax expenditures, coupled with its traditional role as a referee of contending departmental claims for limited direct expenditure funds, presents an opportunity for that office to play a significant role in the effort to achieve tax simplification. There is some evidence that OMB is beginning to recognize this fact and exercise its responsibilities. But much more can and should be done.

We are accustomed to the role played by OMB as it helps to resolve the allocation of funds within the direct budget limit among Departments whose requested funds in the aggregate usually exceed the desired spending level. The OMB needs to fill a similar function where tax expenditures are involved by requiring the Treasury Department and the department with direct program responsibility to reach agreement on the desirability and contours of existing and proposed tax expenditures. Reportedly, it is beginning to exercise this function. Recently, for example, it insured that the Treasury and the Department of the Interior reached agreement on proposed revisions of the special tax provisions for rehabilitation and preservation of historic structures contained in the Technical Corrections Act of 1977.

Coordination of Treasury and other departmental positions on revision or elimination of existing tax expenditures is essential if any real progress toward simplification is to be made. When the Treasury is urging Congress to repeal or revise a tax expenditure, it cannot have another department lobbying overtly or behind the scenes for a different result. But that lobbying is inevitable if the Treasury position has not been formulated in light of the concerns of the department with the expertise and the responsibility for the program area involved. The forces resisting change in the tax expenditure provisions can only be opposed effectively by a Treasury position based on sound tax policy and supported by, for example, an HEW position that the proposed changes also represent sound social policy. The OMB appears to be the logical institutional body to insure this result.

More broadly, OMB should extend this oversight function on a longer term, prospective basis. It has been argued above that simplification where tax expenditures are involved can be effected only after comprehensive, in-depth analyses of the provisions as spending programs. A promising model for consideration would entail the establishment of these studies under the auspices of OMB, with the resources of both the Treasury and the appropriate nontax department marshalled and coordinated, to evaluate and propose repeal, revision, or transfer to a direct program (again, either new or existing).

For example, a task force could be created to evaluate the tax expenditures for low-income housing. Treasury and HUD staffs would participate with OMB representatives. Input into the task force from the building industry, unions, financial institutions, tenant organizations, and the like would be essential. The result should be an analysis and set of proposals that would rationalize and simplify the programs currently financed through the tax system. The executive branch would then be in a position to press its views in a unified fashion, with all departments proceeding from a common data base, set of program guidelines, and recommended courses of action. In this way, the nontax departments would be a factor driving toward simplification in the tax legislative process, rather than a complicating factor as is presently too often the case.

The Council of Economic Advisors. It goes without saying that proposed tax legislation can have a significant impact on the economy. The Council of Economic Advisors (CEA), as the President's consultant on and spokesman for his overall economic strategy, has a role to play in the tax legislative process. What that role is and should be in terms of the simplification issue is less easy to define.

It is clear, for example, that the CEA should evaluate the overall effects of a proposed tax revision package to ascertain its consistency with and contribution to the Administration's economic game plan. A series of Treasury tax reform proposals that would depress the economy at a time when the President is advocating a policy of stimulation obviously must be challenged by the CEA. On the other hand, it is not clear that the CEA and its staff should be involved in particular issues within a tax package once that overall determination has been made.

It is this writer's impression that in the development of the tax reform options for President Carter's consideration in 1977, the CEA and its staff advocated positions on particular items to be included in or excluded from the tax reform package. For example, in the area of business tax incentives, the CEA reportedly favored rapid depreciation techniques, as opposed to an expanded investment credit or corporate rate cuts. Likewise, the CEA staff investigated possible responses to the "expense account living" problem.

It is doubtful that the addition, at the decision-making level, of another set of economists' views on particular items is an aid to tax simplification in terms of either the tax law or the process. Certainly, the CEA staff should contribute its views to the Treasury staff as tax policy options are being considered. But those staff views should not

become institutional positions that the CEA urges on the President. If the CEA does so, and if the views of the CEA economists on a particular item happen to differ from those of the Treasury economists, the President, faced with conflicting views from his own experts, will do what Congress does under similar circumstances. He will compromise by giving each unit something of what it has recommended. But it is likely that this result will be more complex than if, for example, only the Treasury proposal had been considered by the President.

It seems that once the CEA has determined that a particular set of proposals is consistent with overall Administration economic objectives, the cause of simplification will be better served if it does not involve itself in the issue, regardless of whether the Treasury approach on a particular item is marginally better or worse than other possibilities.

The White House Staff. As the title assigned for this paper indicates, the tax simplification issue arises in, and will or will not be resolved through, political processes. The politics involved are partisan and affect the resolution of matters important to the *polis*. The Office of the Presidency, in tax legislation as well as in other substantive areas, is the ultimate determinant of the executive branch position. Tax legislation and the tax legislative process do not and should not operate in a vacuum unrelated to other political, substantive, and legislative concerns of the President.

To ensure that the President's broader interests are identified and related to proposed tax legislation, it has become customary for one or two members of the White House Staff to be assigned the responsibility for processing tax legislative recommendations submitted for the President's decision. To perform these functions properly, it is not essential that the White House Staff members assigned responsibility for tax policy be tax experts. It is crucial, however, that they know what questions to ask and what data to require in order to enable the President to discern clearly the political, economic, and social implications of particular proposals submitted.

It is also important, in the context of tax simplification, that the White House Staff and the President himself be aware of the need to establish and to maintain an orderly process for consideration of tax policy issues. This criterion was not met in the Carter Administration's development of its National Energy Plan. The President's energy plan was heavily dependent on taxes as regulatory devices and on new tax expenditures.[24] Yet news reports indicated that this tax plan evolved

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[24] *See* EXECUTIVE OFFICE OF THE PRESIDENT, ENERGY POLICY & PLANNING, THE NATIONAL ENERGY PLAN (1977).

almost entirely outside the normal process for developing tax legislation in the executive branch. Treasury officials were brought into the process belatedly and, apparently, had little opportunity to analyze the energy tax proposals.

The result was an energy tax package that ran counter to the tax simplification and tax reform themes being propounded by Treasury officials and by the President himself. The failure by the White House to ensure that the expertise available from its own tax policy officials was drawn upon in the development of the energy tax bill illustrates an important point for those concerned with tax simplification: However complex tax legislation and the tax legislative process may be in the hands of those familiar with executing tax policy, placing tax policy formulation in the hands of those who do not have the requisite knowledge is only likely to produce greater complexity and confusion.

Therefore, the principal contribution of the White House Staff to tax legislation is to insure that the process of developing tax legislation is orderly, that the crucial tax questions be raised for the President's consideration, and that the tax policy issues be placed appropriately in the larger framework of the President's political responsibilities and objectives.

The implications of the last point must be considered by those who advocate placing responsibility for development of fundamental tax reform in the hands of an independent, nongovernmental commission.[25] In my view, no President will or should abdicate the responsibility of the executive branch to formulate and present to Congress tax legislative recommendations. The independent commission concept, in effect, reduces the executive branch to the role of being one advocate among others before the proposed commission. Only the veto power would be left to the President as a means of effectively influencing the tax legislative product. Moreover, resolution of questions of basic tax policy do not solely depend on technical expertise; they are the result of the interplay of complex economic, social, and political judgments. The Office of the Presidency must, under our system, be the focus for noncongressional resolution of these matters, whether the subject is taxation or national defense.

Factors Operative in the Legislative Branch

When one pauses to identify the factors that are operative as tax legislation is considered in Congress, the sheer number is quite astonish-

[25] *See* Nolan, *supra* note 1, at 22; Roberts, *et al.*, *supra* note 1, at 334.

ing. With all the variant people, interests, philosophies, sources of influence, and power that are involved, the wonder is not that the tax system is so complex but that it remains as comprehensible as it is. The following discussion provides an undoubtedly incomplete listing of the factors that can and do affect the course of tax legislation in the Senate and the House of Representatives. All the factors, of course, are not active in each piece of tax legislation considered. The presence and forcefulness of participation by each element depend on the concrete issues being considered in a given tax measure. Nevertheless, it is useful to try to identify as many of these factors as possible, since the sum of the elements makes up the process in which the tax system moves toward simplicity or complexity, toward rationality or toward confusion. A clear understanding of the roles played, or potentially played, by each is essential to develop a successful strategy for simplification.

The Factor of Party Structure. ***Democratic Party.*** Party structures can have a significant effect on the course and content of tax legislation in the Congress. This fact has been particularly evident in the House of Representatives over the past few years. Several institutional changes in the Democratic Party operation within the House have produced marked departures from prior tax legislative procedures.

First, in 1974, the Democratic members of the Ways and Means Committee were stripped of their power to act as a committee on committees for Democrats in the House. The power to name Democratic committee members now resides in the Democratic Steering and Policy Committee. As a result, the prior practice of selecting Democratic members of the Ways and Means Committee by virtue of their importance in representing particular regions or sources of influence within the Democratic Party (for example, the major urban areas of the Northeast and Northcentral regions, unions, and so forth) was abandoned. Membership on the Committee now appears to be determined by factors no different from those applicable to other committees.

Second, the Democratic Caucus has assumed a greater role in tax legislation. It can vote to instruct the Democratic members of the House Rules Committee to provide the type of rule under which a tax bill will be considered on the House floor. As a result, the prior ability of the Ways and Means Committee to secure, in effect, an up or down vote on a reported bill, without floor amendments, was modified. For example, on instruction from the Democratic Caucus, the rule adopted for consideration of H.R. 10612 (the Tax Reform Bill of 1975, which ultimately became the Tax Reform Act of 1976) provided for floor consideration of seven amendments that had previously been inserted in

the Congressional Record by Democratic Congressmen Mikva, Jones, and Smith.[26]

Third, the Democratic Study Group, an organization of liberal Democratic House members, has from time to time exerted influence on tax reform legislation. It, for example, served as the political focus of the effort to repeal the percentage depletion allowance in 1975.

Finally, of course, the Speaker of the House can exert a considerable influence on tax legislation. The procedure established in 1977 for the House consideration of H.R. 8444, the National Energy Act, illustrates the Speaker's potential power over tax legislation. Speaker O'Neill established an Ad Hoc Committee on Energy to receive and to coordinate the reports of five standing committees, including Ways and Means, on the President's proposed National Energy Plan.[27] For the first time, a nontax committee was authorized to coordinate the tax legislation reported by the Ways and Means Committee and measures approved by other standing committees. The implications of this procedure in terms of the simplification issue will be discussed further below.

Similar Democratic Party influences on tax legislation are found in the Senate. The role played by the Majority Leader in the tax legislative process, as in the case of the Speaker of the House, depends on both his interest in tax legislation and the manner in which he exercises the powers of the office. Thus in the latter context, seemingly mundane matters, such as establishing a timetable within which the Finance Committee is expected to comply in reporting a bill to the Floor, clearing the Senate calendar for consideration of tax legislation, holding Senate sessions on a two-track system or late into the night, and exercising leadership when parliamentary snarls threaten to bog down the Senate, can have an impact on the course and even the content of the tax bill that is passed by the Senate.

The Senate Democratic Policy Committee reflects the entire spectrum of views among Democrats in the Senate. Therefore, the Committee as such has not taken positions on particular aspects of tax legislation. Nonetheless, it does discuss substantive issues from time to time. In recent years, the Committee has employed the technique of inviting outside tax experts to discuss the issues involved in tax measures pending before the Senate. The practice has been to invite spokesmen with differing points of view to appear and to discuss the issues with Com-

[26] *See* H. Res. 878, 122 Cong. Rec. H. 11677-85 (daily ed. Dec. 3, 1975).

[27] *See* H. Res. 508 and the House floor consideration thereof at 123 Cong. Rec. H. 3349-55 (daily ed. April 21, 1977).

mittee members. Typically, these meetings have been held prior to Senate floor consideration.

For the past decade, an informal group of 15 to 25 Democratic Senators who share a similar view with respect to tax reform issues has existed. The group achieved its greatest formal cohesiveness in 1976 when 15 Senators agreed to sponsor a package of specific floor amendments to the Senate Finance Committee version of the Tax Reform Act of 1976.

Republican Party. By virtue of its decisively minority status in both bodies, the Republican Party as such has had little discernible impact on tax legislation in recent years. Republican alternative proposals are offered and individual Republican Representatives and Senators are prominent in the development of tax bills. But since 1974, Republican Party influence in the Ways and Means Committee has diminished with the enlargement of the number of members of the Committee from 25 to 37, of which 25 are now Democrats. Under the prior division of 15 Democrats and 10 Republicans, a united Republican side, under the forceful leadership of former Representative John Byrnes of Wisconsin, could and did play a significant role in Ways and Means Committee decisions. With the larger Democratic membership, Republican influence depends on the conjunction of their views with those of a sizeable number of like-minded Democrats. Votes within the Committee on the Tax Reform Act of 1976 were often quite close, indicating that the necessary conjunction of views does frequently exist. A similar situation exists in the Senate Finance Committee.

Even during the years of Republican control of the White House, President Ford's successful tax legislative ventures resulted not from Republican Party structure influence within Congress but from agreement reached with a sufficient number of Democratic leaders. Party structures, such as the Senate Republican Policy Committee or the offices of the respective Minority Leaders, have not represented, and do not appear to currently represent, crucial elements in the Congressional consideration of tax legislation.

The Factor of the Committee System. Any strategy to achieve tax simplification must squarely confront the central political element in the tax legislative process—the role of the committee system in Congress and particularly the tax-writing committees. Whether anyone other than the Representatives and Senators who actually serve on the Senate Finance Committee and the House Ways and Means Committee can

accurately discern or analyze all the forces, motivations, and influences that operate within these committees is doubtful. But the following discussion attempts to isolate those elements, identifiable to an outside observer, that are relevant to the political aspects of the simplification issue.

Operation of the Tax-Writing Committees. Of the two tax-writing committees, the Ways and Means Committee has undergone the most significant operational changes in the 1970's. The substantial increase in membership and the changed functions of the Democratic members have already been discussed. (See pages 523-25.) Of equal significance has been the passage of the Chairmanship from Representative Wilbur Mills to Representative Al Ullman. Standing alone, this change in leadership would have altered the Committee's methods of dealing with tax legislation; however, this change, coupled with other shifts in committee operations, has produced a readily perceptible, almost dramatic revision in the way in which the Ways and Means Committee deals with tax legislation.

As part of the 1974 changes, younger, more aggressive Democrats with little background in tax policy analysis became members of the Committee. These new members were less influenced by the exercise of strong authority from the Chairman that had characterized the Mills' years. And Chairman Ullman has appeared to be more inclined to conduct committee business in an atmosphere of open give-and-take, rather than to attempt to impose his views on the committee. This change in approach inevitably has led to a committee that, at times, appears less disciplined and singleminded on tax policy issues than before.

A closely related development has been the opening of mark-up sessions to the public. Formerly, mark-ups of a pending bill were conducted in executive session, generally with only Committee members, Treasury representatives, and members of the Staffs of the Joint Committee on Taxation and the Ways and Means Committee present. Neither lobbyists nor the Representatives' own aides were admitted.

Predictably, open mark-up meetings have produced mixed results. In some respects, the influence of lobbyists seems to have increased. Those representing particular interests can be present to see whether an individual Congressman is, in fact, pressing their case. Some sessions have apparently been disrupted, as lobbyists have called members aside to make additional arguments and, presumably, to exert additional

pressure. In turn, there may be somewhat more prolonged posturing by some Committee members for both lobbyists and press.

On the other hand, the Representatives' own aides can be present, presumably, to give more informed and balanced input to the Committee members. Indeed, in 1975, some Ways and Means members even joined together to employ a single tax expert to provide them with greater tax expertise both in and out of Committee sessions. In addition, under prior practice, lobbyists exerted pressures similar to those now evident in mark-up sessions, but such activities all took place outside the Committee room and away from public notice and scrutiny. Those who needed to know, and could afford to pay lawyers and lobbyists to spend the time to acquire the knowledge, appeared to be readily able to find out what went on in executive sessions.

Open sessions appear to have produced mark-up sessions that are less tidy than before, and it is possible that real negotiations and decision-making have been moved back into the privacy of members' offices; but I believe that the gain in clear public perception of the factors influencing the Committee's deliberations outweighs these disadvantages.[28]

Another change in the Ways and Means Committee operating procedure has resulted both from the volume of the subjects within the Committee's jurisdiction—taxes, social security, welfare, trade, public debt, and health—and the increased membership. Five standing subcommittees have been created to handle the different legislative areas. Although, with the exception of the Health Subcommittee, taxation remains under the entire Committee, the subcommittee system could prove to be an important element in tax simplification efforts.[29] In addition, the full Committee has used task forces to deal with some specific tax issues, the foreign tax rules,[30] and capital formation[31] to date.

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28 This appears also to be the view of one public interest lobby. *See* R. Brandon, J. Rowe & T. Stanton, Tax Politics: How They Make You Pay and What You Can Do About It 89 (1976).

29 *See* Rule 4 of the Rules of the Committee on Ways and Means, *reprinted in* 123 Cong. Rec. H. 1297 (daily ed. Feb. 22, 1977). The Subcommittee on Oversight potentially could be an important factor in tax simplification efforts. For example, the Subcommittee scheduled field hearings on tax simplification in St. Louis in December 1977. Similarly, the Subcommittee on Miscellaneous Revenue Measures could be an effective vehicle for achieving discrete technical changes that would simplify existing rules.

30 The Task Force on foreign tax rules issued a report dealing with certain foreign tax issues. *See* statement of Representative Rostenkowski, 123 Cong. Rec. H. 1917 (daily ed. Mar. 9, 1977).

31 The staff of the Joint Committee on Taxation has prepared a study for the use of the Task Force on Capital Formation, Tax Policy and Capital Formation, 95th Cong., 1st Sess. (Comm. Print 1977).

The sheer volume of Committee nontax business has, I believe, helped to produce some of the problems generally included under the rubric of tax complexity. The full Committee cannot be continually attentive to the multiple aspects of the tax system when urgent issues in the social security system, Medicare and Medicaid, and trade require Committee attention as well. Perhaps the use of subcommittees will alleviate the time pressures, but the experience to date does not provide grounds for optimism.

The tax legislative process might be improved if jurisdiction over some subjects for which the Committee is responsible were placed in another committee. This would enable the Ways and Means Committee to give full-time attention to the tax system. But as the 1977 Senate experience in attempting to reallocate Committee jurisdictions indicates, the anguish of a special interest group that is about to lose its tax preference is nothing compared with that of a Congressional Committee about to lose part of its jurisdiction (that is, power).[32]

Some of the changes that have taken place in Ways and Means Committee operating procedures have also taken place in the Senate Finance Committee; however, in the latter case, the break with the prior order has been much less extreme. The Committee, under the Senate rules, has opened its mark-up sessions to the public, and the size of the Committee has been somewhat increased. But the dominant element in the Committee's operations has, for many years, been Chairman Russell Long, and the revisions in Committee operations have not, in any way, altered this fact.

It is within the foregoing procedural apparatus that the tax-writing committees consider tax simplification proposals. It is now appropriate to turn to the two categories of tax legislation, that is, tax-expenditure provisions and structural provisions, to see how the committee system deals with and either contributes to or mitigates the causes of tax complexity in each.

Tax Expenditure Legislation Aspects. Writers on tax simplification have long recognized that one major source of complexity in the tax laws is the existence of Code provisions that provide federal subsidies or incentives,[33] which are now officially termed "tax expenditures." With the growth in tax expenditures, as previously described, it is no exaggeration to state that the use of tax expenditures constitutes the

[32] *See* the floor debate on S. Res. 4, Committee System Reorganization Amendments of 1977, 123 Cong. Rec. S. 1827 *ff.* (daily ed. Feb. 4, 1977).

[33] *See* notes 1 and 7, *supra*.

single biggest cause of complexity in our income tax system. In the context of tax expenditures, simplification can move in one of two directions:

(1) Elimination of the practice of using the tax system to fund federal financial aid programs

(2) Rationalization of the process by which tax expenditures are developed and implemented so that in both respects the tax expenditure program accurately mirrors a desirable direct expenditure program.

Neither approach guarantees any reduction in the overall complexity of governmental operation. If a complex tax expenditure program is repealed but replaced with an identical direct program, the complexity has been shifted from one governmental unit to another. The tax system gains in simplicity. Whether the net result is a gain or a loss in the overall simplicity of government financial programs is a complex question that needs further study and analysis. The second approach is primarily a matter of budget management, a factor that will be discussed below.

What political aspects must be considered if the first approach to simplification is to be pursued seriously? The first is the willingness of the tax-writing Committee members, both liberals and conservatives, to use the tax system to provide tax solutions to problems in which they are interested. As Senator Long has observed, if he were chairman of a committee with legislative responsibility over direct programs, he would urge adoption of direct subsidies and incentives. He is, however, chairman of a tax committee, and the path to funding programs he is interested in is through the Internal Revenue Code.[34] Further, just as direct expenditure programs can be reproduced in the tax system in the form of tax expenditures, so can regulatory measures be instituted through the tax system.

For example, in 1975, the House Ways and Means Committee decided to take jurisdiction over the entire energy program of the country by proposing a series of tax expenditures and tax regulatory measures.[35] The House appeared to grasp what was happening and debated direct regulatory measures versus tax sanctions and the merits of the tax expenditures (in the latter case, largely using direct spending criteria).[36]

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[34] *See* PEOPLE & TAXES 2, 5 (Aug. 1975).

[35] *See* the Energy Conservation and Conversion Act of 1975, H.R. 6860, H.R. REP. No. 221, 94th Cong., 1st Sess. (1975).

[36] *See* the House floor debate on the 1975 Energy Bill, 121 CONG. REC. H. 5350-5400, 5426-60, 5659-76, 5727-51 (daily ed. June 12, 13, 18, and 19, 1975). The use of the tax system as a substitute for direct regulation is a subject that needs careful analysis. At this point, it is not even clear that we have identified the questions that should be asked to determine whether tax regulation or direct regulation should be employed.

In some instances the Committee approach was upheld, in others it was not. The experience, however, demonstrates that a tax-writing committee can acquire jurisdiction over either a spending program or a regulatory program by the simple expedient of drafting the desired direct program in tax language.

The political attractiveness of tax expenditures or tax regulatory measures to Finance and Ways and Means members becomes more readily apparent when one realizes that in enacting tax expenditures, for example, the tax-writing committees serve both as the authorizing and the appropriations committee. This is a power available to no other committee in either House. Those urging repeal of tax expenditures as the path to tax simplification must, therefore, first recognize that this suggestion is a recommendation that the members of the tax-writing committees decline to exercise a source of considerable political power.

Once a tax expenditure is enacted, the Committee then obtains continuing jurisdiction over a program that quickly acquires a constituency of those involved in the interest or activities affected. The Committee members gain a position of influence in that activity that they might not otherwise be able to acquire. A Senate Finance Committee member interested in pollution control, for example, can gain a political foothold in this area that he would otherwise be denied if he were not a member of the Committee on Environment and Public Works. He can be expected to resist efforts to deprive him of that source of influence.

Likewise, comfortable working relationships develop among lobbyists for the particular tax expenditure beneficiaries, committee members, and their staffs.[37] These relationships would be disturbed even if a tax expenditure program were replaced with a direct expenditure program. New relationships would have to be established with different Senators or Representatives and different staff aides. Thus even if beneficiaries of a tax expenditure program could be assured that they would suffer no loss of financial benefits by a change to a direct program, resistance to the change should still be expected.

It was suggested earlier that the path to simplification in dealing with tax expenditures lies in coordinated studies between the Treasury and the applicable nontax departments under the auspices of OMB. The preceding discussion suggests that the political realities described must

[37] *See* R. Brandon, *et al.*, *supra* note 28, at 80-81. The authors also emphasize the importance of contributions by tax expenditure beneficiaries to the campaigns of members of the tax-writing committees. *Id.* at 79.

be taken into account in formulating any suggested changes. Put more plainly, if the study of a tax expenditure indicates that it should be converted or transferred to a direct expenditure program, consideration must be given to the issue of committee jurisdiction over the resulting direct program. For example, a proposal to convert tax subsidies for oil to direct subsidies, even if the industry can be completely satisfied in regard to the financial benefits, red tape issues, and so forth, will go nowhere in Congress if the result is that jurisdiction over the program is transferred out of the Senate Finance Committee. One would expect a like reaction to similar programs for timber in the Ways and Means Committee.

This is not to say that the issue of committee jurisdiction will defeat all efforts to repeal tax expenditures or to convert tax to direct spending programs. The committee may be willing to give up jurisdiction. In some instances, other political or institutional forces may be brought to bear that are sufficient to overcome the jealous guarding of jurisdictional prerogatives by the tax-writing committees; however, in other instances, legislative and parliamentary expertise will be required to devise a direct program that will nonetheless remain within the jurisdiction of the tax-writing committees.

An example of an apparently successful application of the last strategy has been the proposed optional interest subsidy for taxable bonds issued by state and local governments. It has been assumed that jurisdiction over the direct subsidy program would remain in the tax-writing committees.[38]

The approach adopted by the House in connection with the energy bill in 1977 represents an application of the second approach listed above. The Ad Hoc Committee on Energy was empowered to coordinate tax proposals from the Ways and Means Committee with direct programs recommended by four other standing comittees. By opting for direct measures instead of tax expenditures or tax regulatory measures, the Ad Hoc Committee could have effected a jurisdictional shift from Ways and Means to another committee. If this approach were to be employed in other areas in the future (for example, with comprehensive national health care), it would provide a promising avenue to

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[38] In 1972, S. 3215, proposing a taxable bond subsidy, was reported favorably by the Senate Committee on Banking, Housing, and Urban Affairs. S. REP. No. 836, 92d Cong., 2d Sess. (1972). The measure was then referred to the Senate Finance Committee, where it died. The House-passed version of the Tax Reform Act of 1969 also contained a taxable bond subsidy, and no question was raised concerning the jurisdiction of the tax-writing committees.

tax simplification via elimination of tax expenditures.[39] Successful implementation of such a strategy, however, would turn on the development of much more sophisticated approaches to and analyses of tax expenditures or tax regulatory proposals by those who are not members of the tax-writing committees than presently exist.

Anyone who doubts the importance of development of tax legislative techniques along the lines suggested above should consider the example of ERISA. There, the tug and pull over jurisdiction between the tax-writing and labor committees produced a statute of incredible complexity. The bifurcated jurisdiction that continues to exist in both the executive branch and the Congress has, in turn, resulted in additional complexity for tax administrators and advisers alike.

Structural Legislation Aspects. It has been previously suggested that in certain areas, notably those covered by Subchapters C, J, K, and M, simplification requires a rational and coherent statutory structure, albeit a complex one. To what extent are the political processes operative within the tax-writing committees conducive to achieving such a goal?

The major problems are immediately evident. First, as noted above, the nontax load of each committee means that all of its time cannot be devoted to the tax system. Second, in recent years, the equity and efficiency issues created by tax expenditures (tax reform) have dominated the time the committees could devote to tax legislation. Third, members of the committees have shown little restraint in seeking to attach tax measures in which they are personally interested to the first tax vehicle that presents itself.

This last point introduces the germaneness principle. The tax-writing committees are inherently incapable of developing the comprehensive structure necessary to rationalize, for example, Subchapter

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[39] For resolution of the issues in the Energy Bill, *see* the report of the House Ad Hoc Committee on Energy, The National Energy Act, H.R. Rep. No. 543, 95th Cong., 1st Sess. (1977). The Chairman of the Ad Hoc Committee, Representative Ashley, noted that the procedure followed involved the consideration of 113 separate legislative initiatives by some 200 members of the House. Chairman Ullman, of the Ways and Means Committee, stated that the procedure was one that was going to have to be employed in the future as Congress addresses complex national problems. 123 Cong. Rec. H. 8173, 8183 (daily ed. Aug. 1, 1977).

A modified form of this approach is the joint referral process under which a tax expenditure bill is referred both to the tax-writing committee and the authorizing committee with jurisdiction over corresponding direct programs. Senator Long has demonstrated that he is alert to the threat to Finance Committee jurisdiction that is implicit in this process. *See* 123 Cong. Rec. S. 2373 (daily ed. Feb. 7, 1977), in which Senator Long objected to and prevented the joint referral of a tax expenditure bill to the Senate Finance Committee and the Senate Labor Committee.

C. This work must be done in the Treasury with the participation and guidance of such groups as the American Law Institute, the Tax Section of the American Bar Association, the American Institute of Certified Public Accountants, and the like. Understandably, however, the Treasury has little enthusiasm, even if it had the requisite staff and organizational structure, for developing and presenting a complex technical bill that becomes the vehicle to which Senators and Representatives add all the miscellaneous special interest provisions in which they happen to be interested.

In this area, the method of operation employed by the Ways and Means Committee in considering the pending Technical Corrections Act of 1977 [40] represents a potentially promising development. The bill itself was conceived and developed by the Joint Committee and Treasury staffs to correct technical problems that had surfaced following passage of the Tax Reform Act of 1976. Consideration of the Technical Corrections Bill, however, was imperiled by the plethora of special interest amendments that many committee members wished to attach to it. Chairman Ullman created an ad hoc subcommittee to rule on the germaneness of these proposed amendments to the bill. Measures that were not truly technical corrections of the 1976 Act were ruled out of order. Although the ad hoc committee's decisions were overruled in a few instances, the procedure by and large accomplished its objective. The overwhelming number of provisions in the Technical Corrections Bill reported out by the Committee were technical corrections of the 1976 Act. Special interest provisions were kept to a minimum.[41] The House procedures regarding floor amendments then protected the integrity of the Bill as it was considered by the full House. A similar procedure is essential if major technical simplification and rationalization of inherently complex structural elements in the income tax system are to be achieved.

There is, as yet, no evidence in the Senate Finance Committee of a willingness to exert similar self-discipline. The House-passed Technical Corrections Bill, referred to by the Subcommittee on Taxation and Debt Management, immediately became the prospective vehicle for those seeking repeal, emasculation, or deferral of the carryover basis [42] rules adopted in 1976. Nor has the Senate exhibited any inclination to enforce a strict germaneness rule during floor debates.

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40 H.R. 6715, 95th Cong., 1st Sess. (1977).

41 *See* H.R. Rep. No. 700, 95th Cong., 1st Sess. (1977). The special interest provisions that were added to the bill were identified and strongly denounced by seven dissenters on the Ways and Means Committee. *See id.* at 273.

42 I.R.C. § 1023.

In this situation, the political prospects for simplification through rationalization of the necessarily complex technical structure of the income tax system depend on (1) the enforcement of strict germaneness procedures in the House Ways and Means Committee, and (2) the refusal of House Conferees to accept any nongermane amendments added in the Senate. The latter proviso presents obvious problems, as it is politically difficult to expect the House Conferees to secure the agreement of the Senate Conferees to recede on every extraneous amendment added in the Senate.

Private Relief Legislation Aspects. Another frequently noted source of tax complexity is the practice of drafting private relief bills as tax provisions of general applicability.[43] From a political standpoint, this practice is, in many respects, rooted in the same jurisdictional issues discussed in connection with tax expenditures, that is, many of the existing ad hoc tax provisions, if cast as direct private relief bills, would end up under the jurisdiction of the Judiciary Committees. Thus the political pressures for a tax solution to private relief problems are the same as those for tax solutions to more general problems.

Judgments about essentially private relief provisions need to be made with some discrimination. The response to such measures should differ depending on whether the private relief provision is an amendment to a tax expenditure provision or a structural provision of the income tax itself. If amendment of an existing tax expenditure program is involved, then the private relief measure is generally an expansion of the scope of, or an easing of restrictions on, a federal spending program. In this context, the phrase "tax simplification" has little relevance. The relief provision must be judged in spending program terms and may prove to be an improvement, when tested under criteria applicable to the spending program. If unacceptable complexity results, it is "spending complexity," not "tax complexity." The only real answer to the proliferation of these kinds of private relief provisions in the tax law is the elimination of the underlying tax expenditures themselves.

Private relief provisions that represent deviations from the application of structural tax rules themselves constitute new tax expenditures. In these situations, the previous discussion of the handling of tax expenditures by the tax-writing committees is equally applicable.

Other Committees. Committees other than the Finance and Ways and Means Committees influence the tax legislative process. It is, of course,

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[43] *See* Roberts, *et al.*, *supra* note 1, at 337.

not surprising to find some of these committees involved in tax issues. The Joint Economic Committee is, in a sense, the Congressional counterpart to the Council of Economic Advisors. It examines and reports on the economic impact of tax revisions in terms of anticipated effects on employment, inflation, growth, production, and the like. The Senate Foreign Relations Committee, with its jurisdiction over tax treaties, is not an unexpected presence in Congressional consideration of the implementation of the income tax system in an international context.

But the increased understanding of the scope and importance of tax expenditures has begun to compel other nontax committees into the tax legislative process. Members of these committees are beginning to understand that the tax-writing committees, via the tax expenditure mechanism, can have a significant impact on the policies being pursued through direct authorization-appropriation programs. And there is a growing perception that the two routes must be coordinated.

This perception was reflected in the 1974 amendment of the House rules. House Resolution 988 amended House Rule X to provide that each standing legislative committee is authorized to conduct studies and investigations of the way tax policy affects subjects within the committee's jurisdiction. The stated purpose of the amendment was to enable each legislative committee to coordinate tax and nontax issues relating to the same area of national policy.[44] As far as can be determined, this power has been little utilized by House legislative committees.[45] Nevertheless, the new rule carries the potential for significant involvement in the tax legislative process by nontax committees in the House.

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[44] *See* H.R. REP. No. 916 (Part II), 93d Cong., 2d Sess. 65-69, 119 (1974).

[45] On June 15, 1977, the Subcommittee on the City, of the House Banking, Finance, and Urban Affairs Committee, did hold hearings on federal tax policy and urban development.

In addition, on June 8, 1976, the chairman of the House Committee on Banking, Currency, and Housing, the Senate Committee on Banking, Housing, and Urban Affairs, and the House Committee on the Budget jointly requested that the Director of the Congressional Budget Office conduct a "study of possible alternatives or additional rental housing subsidies which could substitute for existing tax shelter subsidies." The chairmen recognized that in order to implement alternative forms of housing subsidies, "close co-ordination will be necessary among the committees with legislative jurisdiction over housing programs and taxation." *See* CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES, App. A, at 107 (May 1977).

S. Res. 4, *supra* note 32, initially required that "each [Senate] Standing Committee exercise comprehensive policy oversight (*i.e.,* study and review) for tax expenditures related to subject matters within its jurisdiction and submit to the Senate appropriate reports and recommendations." The provision was deleted in the Resolution reported to the floor by the Temporary Select Committee to Study the Senate Committee System, primarily because of the opposition of Finance Committee Chairman Long. *See* 123 CONG. REC. S. 1629, 1640 (daily ed. Jan. 28, 1977) (statement of Senator Kennedy).

The principal nontax committees active in the tax legislative process are the House and Senate Budget Committees, created as a result of the Budget Reform Act of 1974. In this Act, a statutory definition of "tax expenditures" was adopted, tax expenditures were required to be included in the President's annual budget, and the Budget Committees were directed "to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies and programs with direct budget outlays, and to report the results of such studies to the Senate [House] on a recurring basis." [16]

Each of the budget committees established a task force to deal specifically with tax expenditures. Both task forces held hearings on particular tax expenditures, with the House Budget Committee Task Force appearing to have made a greater impact in terms of carrying out studies of existing tax expenditures [17] and effectively preventing, through the mechanism of the budget resolution, the consideration of some proposed new tax expenditures.[18]

From the standpoint of traditional tax simplification analysis, of course, the presence of nontax-writing committees in the tax legislative process is a factor driving toward complexity. More interests have to be dealt with and, typically, compromised. But from the standpoint of insuring that if tax expenditures are to be employed they are properly integrated with an overall budget for the United States and other policies, the presence of the nontax committees is both logical and necessary.

In the Senate, under present procedures, the nontax committees can only enter the process during floor debates. They have begun to do so and this, in turn, has begun to test the delicate sensibilities of the chairmen of both tax and nontax committees, as the jurisdictional (power) issues presented by tax expenditures become more widely appreciated. Both of these points will be made clearer by considering the factor of the revised budget process as a political element in the tax legislative process.

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[16] Budget Act, *supra* note 21, at §§ 101-102, 601.

[17] *See, e.g.*, the *Hearing on Proposed College Tuition Tax Credits Before the Task Force on Tax Expenditures, Government Organization and Regulation of the House Budget Comm.*, 95th Cong., 1st Sess. (April 27 and May 11, 1977). The same task force held hearings on Feb. 24, 1976, on President Ford's proposals for new tax expenditures for public utilities and for a mortgage interest tax credit. In 1975 the Task Force on Tax Policy and Tax Expenditures of the Senate Budget Committee held "seminars" on *Encouraging Capital Formation Through the Tax Code*, 94th Cong., 1st Sess. (Sept. 18, 19, 1975), and on *DISC: An Evaluation of the Cost and Benefits*, 94th Cong., 1st Sess. (Sept. 26, 1975). The Senate Budget Committee no longer employs task forces.

[18] *See* the House Budget Comm., Report on the First Concurrent Resolution on the Budget—Fiscal Year 1977, in which President Ford's recommended new tax expenditures were specifically rejected. *See id.* H.R. Rep. No. 1030, 94th Cong., 2d Sess. 39, 46 (1976).

The Factor of the Budget Process. The formal recognition that a rational budget process must involve consideration of spending through the tax system as well as direct spending has begun to affect the tax legislative process in a very concrete manner. Two examples from recent tax legislative experience illustrate that if tax expenditures are to be employed, the budget process, carried to its logical conclusion, potentially can affect both the procedure by which tax legislation is considered and its substantive content.

The first illustration is the confrontation that occurred between the Senate Budget Committee and the Senate Finance Committee on the Senate floor during consideration of the Tax Reform Act of 1976. In the First Concurrent Resolution on the Budget for Fiscal Year 1977 (adopted in 1976), both the House and the Senate had targeted an aggregate tax reduction of $15.3 billion. In each case, the Budget Committee reports made clear that the reduction was to be comprised of $17.3 billion in general tax reductions and a $2 billion net reduction (tax increase) in tax expenditures.[49] Only the net $15.3 billion figure, however, appeared in the Budget Resolution itself.[50] The Senate Finance Committee bill reached the target result by providing only a $1 billion tax increase through net reductions in tax expenditures and correspondingly provided for a smaller general tax reduction ($15.5 billion instead of $17.3 billion) than specified in the Senate Budget Committee Report.[51]

At the outset of the Senate floor debate on the Tax Reform Act, the Budget Committee challenged the Senate Finance Committee bill as not being in compliance with the Budget resolution. Senator Long argued that only the net figure in the Budget resolution itself ($15.3 billion) had to be met by the Senate Finance Committee; the mix of tax reductions and tax increases (through reductions in tax expenditures) was within the discretion of the Finance Committee. Senator Muskie, Chairman of the Budget Committee, argued that the $15.3 billion figure was not one drawn out of thin air and that the Senate had, in fact, approved the Budget Committee method of arriving at the

[49] S. REP. No. 731, 94th Cong., 2d Sess. 8 (1976); H. REP. No. 1030, 94th Cong., 2d Sess. 23 (1976).

[50] S. Res. 109, 94th Cong., 2d Sess. (1976).

[51] It was generally assumed that the $800 million additional tax reduction required to meet the budget resolution target figure would be made up on the Senate floor, either through increased tax expenditures or through more extensive general tax reductions. This expectation was more than realized, as Senate floor amendments of both types were adopted. The Senate bill thus went to conference with a net tax reduction far in excess of the budget resolution target figure.

$15.3 billion figure, a method that called for a $2 billion net reduction in tax expenditures.

From a technical legal standpoint, Senator Long had a strong argument. From the standpoint of the rational budget process envisioned by the Budget Reform Act of 1974, Senator Muskie was clearly correct. Although the issue was debated vigorously at different times during the Senate floor consideration of the 1976 Act, no definitive resolution of the matter was reached.[52]

As a practical matter, Senator Long's view was upheld by the Senate, since the bill that left the Senate floor bore no relation to the Budget Resolution. The Budget Resolution reappeared, however, as a potent force in the Conference Committee consideration of the Tax Reform Act, with the resulting bill more closely conforming to the Budget Resolution than did the Senate Finance Committee bill ($17.3 billion in tax cuts and a $1.6 billion net reduction in tax expenditures for fiscal year 1977).[53]

The 1976 confrontation on the Senate floor emphasized the factor of committee jurisdiction, as discussed above. The Budget Committee was asserting that if it was to carry out its responsibilities under the Budget Act, it had to exercise some control over the level of tax spending. The Finance Committee was, in effect, arguing that the question of how tax increases or reductions were to be made was exclusively within its jurisdiction; it could raise, lower, or alter tax expenditures as it saw fit. From a budget process standpoint, the Senate Finance Committee position meant that tax expenditures would be totally beyond the control of the Budget Committee and essentially outside the budget process. For example, under the Senate Finance Committee view, it could comply with a Budget Resolution direction for tax increases by raising tax rates rather than reducing tax expenditures, even though the latter was the method contemplated by the Budget Committee.

The second major intrusion of the budget process into the tax legislative process occurred in connection with the Senate floor consideration of the Energy Production and Conservation Tax Incentive Act of 1977. The Senate Finance Committee bill completely rejected the President's reliance on taxes as a regulatory measure to increase conservation. Instead, the Senate Finance Committee relied almost exclusively on a whole range of new tax expenditures (totalling some $40 billion by

[52] *See, e.g.*, 122 CONG. REC. S. 9565-83, 9711-26, 9998-10011, 13583-88 (daily ed. June 16, 17, and 21, and August 5, 1976).

[53] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, SUMMARY OF THE TAX REFORM ACT OF 1976, 94th Cong., 2d Sess. 108 (1976).

fiscal year 1985).[54] Included in the list of tax expenditures were a number of refundable tax credits.[55]

On the Senate floor, the Senate Appropriations Committee raised the point that the refundable feature converted the tax credit provisions into spending authority to the extent of refundability. As such, the bill had to be referred to the Appropriations Committee for its consideration.[56] During the course of the debate over the Appropriations Committee position, it became apparent that the refundable element in the tax credit had, for the first time, alerted a number of Senators to the fact that the Senate Finance Committee could take jurisdiction over the entire federal budget by simply providing tax expenditures for each direct budget item.[57] Interestingly, Senator Long acquiesced in the Appropriations Committee position.[58] The bill was referred to the Appropriations Committee and immediately reported out with an Appropriations Committee amendment deleting the refundable features. Senator Long then restored refundability by a floor vote rejecting the Appropriations Committee amendment.[59]

The jurisdictional issue, although sharply focused by a refundability provision, is conceptually the same for any tax expenditure, whether refundable or not. If the Appropriations Committee has jurisdiction over the refundable portion of a tax expenditure, it should logically have jurisdiction over the nonrefundable element as well. The Budget Act recognizes that tax expenditures constitute federal spending; from this perspective, the Appropriations Committee is bypassed by nonrefundable tax expenditures just as it is by refundable tax expenditures. Admittedly, the refundability issue makes the jurisdictional question easier to perceive, but as a matter of rational coordination of tax and direct spending, all tax expenditures should be referred to the Appropriations Committee. Senator Long, indeed, indicated that when the investment credit was originally enacted, he himself had raised the question of whether the tax subsidy was not within the jurisdiction of the Appropriations Committee. Apparently, however, the answer given at that time was that the jurisdiction of the Appropriations

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54 S. REP. No. 529, 95th Cong., 1st Sess. (1977) on H.R. 5263.

55 The tax credits for residential energy conservation and certain of the business conservation tax credits were refundable.

56 Technically, the Appropriations Committee amendment provided that the bill be referred to the Appropriations Committee with instructions to that committee to report the bill back immediately with an amendment deleting the refundable portion of those tax credits that had not yet been subject to Senate votes. 123 CONG. REC. S. 18037 (daily ed. Oct. 28, 1977).

57 *See* statement of Senator Chiles, 123 CONG. REC. S. 18041-42 (daily ed. Oct. 28, 1977).

58 123 CONG. REC. S. 18044 (daily ed. Oct. 28, 1977).

59 *Id.* at S. 18052.

Committee did not attach.[60] To push the logic of the matter a little further, it could be argued that all tax expenditure proposals should be jointly referred to the Senate Finance Committee and the appropriate *authorizing* committees, with the resultant legislation then passing through the Appropriations Committee process.

Senator Long's acceptance of the Appropriations Committee jurisdiction over refundable tax expenditures during the 1976 floor debate represented less of a concession than might at first appear. Senator Long did not agree that the Budget Act required the referral of all refundable credit issues to the Appropriations Committee. Indeed, the Budget Act appears to require only that refundable credits included in the bill reported out by the Finance Committee be referred to the Appropriations Committee. Thus floor amendments, including even those by the Finance Committee itself, that involve refundable credits are outside the scope of the joint referral rule. The jurisdictional issue therefore can be expected to be raised with respect to both the refundable and the nonrefundable portions of tax expenditures as Senators understand and explore the budget implications of the tax expenditure concept more thoroughly.[61]

The intrusion of the budget process into the tax legislative process, in terms of the simplification-complexity issue, pushes in opposite directions. The presence of the budget factor makes the tax legislative process more complex.[62] Moreover, when tax expenditures are analyzed as spending programs, the structure of tax expenditures is inevitably driven toward the use of refundable tax credits that are more precisely attuned to achieve the desired objectives (*e.g.*, income related, incremental, *etc.*). Further, the treatment of the amount of the credit for income computation purposes is also raised. For example, should the amount of the credit be included in income or should it reduce basis? These refinements move in the direction of more rational, effective, and equitable spending programs. But they are also more complex and thus move away from the tax simplification objective.

[60] *Id.* at S. 18040.

[61] *See* § 401(b)(2) of the Congressional Budget Act of 1974. Senator Kennedy introduced S. Res. 326, 95th Cong., 1st Sess. (1977), to provide joint jurisdiction over *all* tax expenditures among the Senate Finance Committee, the authorizing committee in whose substantive jurisdiction the tax expenditure falls, and the Appropriations Committee. *See generally* Surrey & McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. Ind. & Comm. L. Rev. 679 (1976), for an analysis of the implications of the revised Congressional budget process for the consideration of tax expenditures.

[62] The reverse may also be true: Tax expenditures can complicate the budget process. For example, in 1977, supporters of tax credits for education costs succeeded in adding funds for that item to the Budget Resolution. 123 Cong. Rec. S. 14510 (daily ed. Sept. 9, 1977).

The above developments suggest that a traditional analysis of tax simplification-tax complexity may not provide the relevant criteria when dealing with tax expenditures. If one emphasizes the "expenditure" element of the term, the question of simplification might best be raised by asking: When does an authorizing or appropriations committee worry about complexity in a direct spending program? What criteria do these committees employ to determine when a program would be too complex? From this perspective, tax expenditures can be viewed as "simple" if a corresponding direct program can be regarded as "simple." On the other hand, the necessity of translating a "simple" direct program into "tax" language may produce a complex and irrational spending program.

The Factor of Floor Debate. A major determinant of the simplicity or complexity of a tax provision is the method by which tax legislation is considered on the floor of the House and the Senate. The polar procedures are the "open" rule of the Senate, under which a Senator can offer any tax amendment to any tax bill, and the "closed" rule formerly employed by the House of Representatives, under which no amendments to tax bills were permitted during floor debate. As noted above, the House rule has been modified so that it is becoming increasingly common for tax bills to be reported to the floor under a "modified closed rule," permitting specified amendments to a tax bill to be offered on the floor of the House.

The "closed" rule of the House has been criticized both by House members who are not on the Ways and Means Committee and by tax reformers who have seen their efforts frustrated in the Ways and Means Committee deliberations. From the standpoint of tax simplification, however, it seems clearly evident that the House procedure represents the only path through which significant tax simplification can be achieved. The Senate rule invites and produces a bill that is hopelessly complex and may even contain self-contradictory provisions when it leaves the floor.[63] Amendments offered on the Senate floor are frequently less carefully drafted than those provisions that emerge from the tax-writing committees. And it is not always possible, because of time pressures, for the legislative draftsmen to clean up and rationalize the Senate floor amendments during the Conference Committee consideration of the bill.[64]

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[63] For example, the Senate version of the Tax Reform Act of 1976 contained two inconsistent provisions dealing with the deductibility of the costs of attending foreign conventions.

[64] Hence the need for the Technical Corrections Act of 1977.

The Senate "open" rule is a prescription for a tax statute that is unnecessarily complex, however complexity is defined. Until the Senate is prepared to adopt a form of modified "closed" rule such as now exists in the House or until it employs a much more strict germaneness rule than is presently followed, the Senate floor debate procedure is a force that will move the tax system inevitably toward greater complexity.

To this writer, the present House modified "closed" rule represents an appropriate balance between the ability of members of the House who are not on the Ways and Means Committee to offer carefully considered and responsible amendments and the need to avoid the chaos that results from the unlimited "open" rule followed in the Senate. The Senate rule simply places too great a burden on the Conference Committee, operating as it almost always does within tight time constraints, to produce tax legislation that is optimal, viewed from the criterion of tax simplicity.

The Factor of Legislative Drafting. Drafting of tax statutes, as with other legislation, is the responsibility of the Offices of House Legislative Counsel and Senate Legislative Counsel respectively. Tax legislative drafting has been criticized as being inordinately complex and marked by the employment of unnecessarily arcane language and drafting techniques.[65] In my view, these criticisms are wide of the mark. The objective of tax legislative drafting is not to produce a statute that is easily understood, but rather a statute that, if understood, cannot be misunderstood. In short, clarity and freedom from ambiguity for those who have the technical skills to understand the statute are far more important than readability.[66] By and large, I believe that the tax legislative draftsmen fulfill this function very ably. The few instances in which this judgment is qualified, notably concerning the notorious Code Section 341(e), are really exceptions that prove the rule, rather than illustrations of a more prevalent problem running through tax legislative drafting.

This is not to say, however, that in regard to drafting the tax statute is not susceptible to clarification. In this respect, I believe that significant simplification (in terms of understandability) would be achieved if the Internal Revenue Code were divided into two major chapters under each of the tax systems. For example, concerning the income tax,

[65] *See, e.g.,* Wriston, *The Scandalous Form 1040*, Christian Science Monitor, Apr. 13, 1977, *reprinted in* 123 Cong. Rec. S. 13196 (daily ed. Aug. 1, 1977) (statement of Senator Hatfield).

[66] Under this view, to be sure, a heavy responsibility is imposed on the Internal Revenue Service to insure that the instructions accompanying the individual tax return forms are clear and understandable to the ordinary citizen.

Chapter 1 should contain only those structural provisions that are necessary to implement a tax on net income. This chapter would include the rates, the definition of gross income, the listing of the deductible costs of producing that income, the annual accounting period, the rules for computation of gains and losses, the definition of the taxable unit, the treatment of corporations and shareholders, and the treatment of international transactions. Chapter 2 would contain all tax expenditure provisions. There are some apparent technical problems in implementing this suggestion, but it appears to be worth studying.

Such a division would produce significantly greater clarity in the tax statute itself. On the one hand, the structural provisions that are essential if we are to employ a tax on net income would be readily and clearly identifiable. In terms of tax expenditures, Congressmen, the executive branch, and the tax-paying public would be clearly advised that the tax system is being utilized to effect spending programs. These provisions would be irrelevant to those who did not wish to participate in the programs or were ineligible for them. Such a division, moreover, would make it very clear that the major cause of complexity in the income tax system does rest with the tax expenditure provisions and not primarily with the structural provisions necessary to implement the income tax system as such. As noted above, this does not mean that some of the structural provisions will not themselves be complex. But the complexity issue, in regard to structural provisions, will clearly be seen in terms of the necessity for a rational and coherent statutory structure, which, as has been noted throughout this paper, is a consideration that is independent of the complexity issue in regard to tax expenditures.

Another recommendation in the tax simplification-tax complexity discussions has been that tax statutes be drafted in more generalized form, with the necessary detail supplied by Treasury regulations and rulings.[67] Where structural provisions of the income tax are concerned, this suggestion has great merit. Existing examples include the consolidated return regulations, the regulations issued under Code Section 305(c), and the regulations yet to be issued in the debt-equity area under Code Section 385. In such instances, the use of a generalized statute as a drafting technique has much to recommend it.[68]

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[67] *See, e.g.*, Roberts, *et al.*, *supra* note 1, at 339.

[68] It should be noted, however, that Congress has not been loathe to intervene in the administrative process. Examples include its codification in 1969 of the "advertising regulations" applicable to tax-exempt organizations in Section 513(c); its codification in 1969 of the original regulations on stock dividends in Section 305(b) (although it then gave back broad regulatory authority to the Treasury under Section 305(c)); its deferral

The suggestion of generalized statutory techniques, however, may have less relevance where tax expenditures are concerned. Is it desirable for Congress to delegate the drafting of the details of a spending program to the Internal Revenue Service and the Treasury Department? Such a delegation would simply shift the focus of all the political forces that have been identified above, now operative in the Congressional process, to the executive branch of the government. Is such a shift desirable either as a matter of the proper operation of a representative form of government or as a method of reducing the complexity of the tax system? Generalized statutes in the area of tax expenditures will not reduce the complexity of regulations or tax forms. The suggestion may also involve the potential for less open operation of the political factors that are clearly evident in the Congressional process at the present time. Whether these factors contribute to complexity or simplicity may be less important than the fact that they operate in the relatively open public atmosphere that characterizes the Congressional tax legislative process. In this context, comparison to the drafting techniques adopted for direct programs would be useful.

The Factor of Staff Influence. It is obvious that the influence of staff personnel can be crucial, and sometimes decisive, on the course of tax legislation. The responsibilities of most Senators and Representatives do not permit them to immerse themselves in the details of proposed tax legislation. Thus Senators and Representatives rely, to a substantial extent, on their own staff personnel for analysis and advice on particular tax proposals. These individuals may be members of the Senator's or Representative's own staff, of a committee or subcommittee staff, or of a Congressionally created office.

The presence of the staffs of the Joint Committee on Taxation, the Senate Finance Committee, the Ways and Means Committee, and the Treasury in the tax legislative process are familiar and expected. As has been true in the executive branch and in the Congress itself, however, the circle of staff influence on tax legislation has been steadily increasing beyond the staffs of the tax-writing committees or the individual staff members of Senators and Representatives on the tax-writing

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in 1976 of the effective date of Rev. Rul. 76-215, 1976-1 C.B. 194 (relating to the availability of the foreign tax credit under certain production-sharing contracts); its concern over the proposed articulation of rules governing fringe benefits; and the Senate's vote in 1977 to defer the effective date of Rev. Rul. 77-85 1977-1 C.B. 12 (dealing with investment annuities). In all these instances, the Treasury and the Internal Revenue Service were simply working out the implications of basic structural rules. But Congress was unwilling to support the Treasury and Internal Revenue Service positions, although they were developed with considerable care and study in each instance.

committees. The expanding role and influence of staff personnel who are not themselves in a position to directly affect tax legislation is accounted for by the wider understanding and appreciation of the tax expenditure concept.

The following discussion attempts to identify both the tax and the nontax staff influences in the tax legislative process. As in the case of the factors heretofore discussed, their role in moving the tax system toward complexity or simplicity is assessed. It must be emphasized that the turnover of staff personnel, especially at the Congressional level, tends to be quite rapid. Therefore, the influence of particular staff positions may rise and fall from session to session as these changes occur. Nonetheless, it is useful to identify those staff influences that have emerged in recent years, as well as the more traditional tax staff influences.

Staff of the Joint Committee on Taxation. The Staff of the Joint Committee on Taxation (JCT) is the most influential staff in Congress on tax issues. That staff, composed of lawyers, economists, and accountants, is the one relied on by both tax-writing committees for the substantive development and evaluation of tax proposals. Members of Congress who are not on the tax-writing committees also look to this staff for recommendations, for assistance in developing and drafting tax legislation, and for data and evaluation of tax measures. The JCT staff also serves as the primary staff liason between the tax-writing committees and the Treasury tax office. As in the case of the Treasury staff, the JCT staff is the focal point of attention by lobbyists who seek to secure staff backing for, or at least staff understanding of, positions being taken by interests represented by the lobbyists.

The JCT staff is thus at the center of the political pressures that swirl around the tax legislative process. As a result, the role of the staff is an extremely delicate one. If the staff is to retain its credibility with the Senators and Congressmen whom it is obligated to serve, it necessarily must maintain an evenhanded method of operation. It is important that the staff retain the high level of confidence it enjoys in Congress. It is therefore not a criticism to indicate that, from the standpoint of tax simplification, because of the political constraints under which JCT staff labors, it can have only a limited impact on moving the tax system in any particular direction, even though individual members of the staff might have quite strong views on the proper course to take. This necessity for maintaining a relatively neutral stance results in the rather bland analyses that the staff prepares for consideration by the Finance

Committee and the Ways and Means Committee with respect to particular tax proposals. Indeed, the 1977 study on tax simplification by the JCT staff, *Issues in Simplification of the Income Tax Laws*, indicates the difficulties that the JCT staff encounters in leading the tax-writing committees in one direction or another. The study accurately and dispassionately sets forth the causes of tax complexity without providing any value judgments on the identified sources of complexity. Various alternatives are presented for achieving tax simplification. But apart from a recommendation for periodic review of special provisions, the JCT staff took no position on whether one of the possible legislative avenues to tax simplification is more or less desirable than any other.[69]

In the past, the JCT staff was relatively small and operated under continual time pressures, as the result of the multiple demands made on it both by the tax-writing committees and by other members of the Senate and the House. The JCT staff has now been expanded because of the direct increase in the number of staff members (approximately 60 to 70 people) and by an arrangement with the General Accounting Office that provides an additional 75 to 100 technicians to work with the JCT staff. The time pressures on the staff remain, however, as does the need to maintain its credibility among legislators with widely divergent views on tax policy issues. These factors combine to make it very difficult for the staff to develop the kind of long range approach to structural changes in the tax system that is necessary to achieve genuine tax simplification.

But, as noted above, even if the JCT staff had the requisite time and resources to undertake long-term studies, it is doubtful that it would be in a position to advocate a particular set of controversial proposals. Inevitably, there would be members of the tax-writing committees who would not agree with the staff recommendations. As a result, the JCT staff would risk losing the confidence of those Senators and Representatives, which is the source of the present strength of the staff. The staff, as it has done in the past, will be in a position to analyze questions

[69] *See* Staff of the Joint Committee on Taxation, Issues in Simplification of the Income Tax Laws 8 (Comm. Print 1977). The concept of "periodic review" of tax expenditures has been the basis for the five-year cutoffs employed for various tax expenditures. The concept, however, has been honored more in the breach than in the observance, since there has been no effort to establish a timetable and a staff organized to insure that the requisite studies would be available at the times scheduled for "review." Generally the experience has been that the original five-year period is simply extended, with Congress having no more information on the efficiency, effectiveness, and equity of the provision than it had at the time of original implementation.

Under Section 8022(2) the Joint Committee on Taxation is directed to investigate measures and methods to simplify the tax system and to publish proposed simplification measures from time to time. *See also* Woodworth, *The Federal Tax Legislative Process*, 25 Nat'l Tax. J. 405 (1972).

involving tax simplification issues. The increased staff capability may enable the JCT staff to exert a strong influence on simplification of particular technical structural provisions. Comprehensive proposals that have a clear and consistent viewpoint must necessarily emanate from sources other than the JCT staff.

Treasury Staff. In the Congressional process, the Treasury staff plays a different role from that discussed in connection with its functioning within the executive branch in the development of tax legislative proposals. As the Congress considers tax proposals, the Treasury operates as an advocate for tax legislative initiatives of the Administration and presents Administration positions on tax proposals emanating from Congress. Realistically, only the Treasury staff has the requisite capability in terms of manpower and resources to develop and advocate in Congress those consistent and principled positions that can lead to genuine tax simplification. If the Treasury does not perform this function, it will simply go unperformed. As indicated in the prior discussion, there is no element within Congress that is itself capable of developing and formulating such positions.

During the period 1971-1976, the Treasury staff lost almost all its influence within the tax-writing committees and with Congress generally. This lack of confidence was the result of many factors. One reason, of course, was that the Treasury represented a Republican administration before a Democratically controlled Congress. Changing philosophies and personnel also helped to produce this result. Fairly or unfairly, during this period the Treasury came to be viewed by Representatives and Senators interested in tax reform and simplification as an additional obstacle to be overcome, rather than as a source of support.

The decline in the Treasury influence within Congress produced unfortunate results in the tax legislative process. The requisite studies and analyses of crucial tax issues simply were not available. Those studies that were produced by the Treasury to support its own tax expenditure preferences were suspect as being more the result of political interests than of objective analyses.[70]

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[70] *See* U.S. TREAS. DEP'T, THE OPERATION AND EFFECT OF THE DOMESTIC INTERNATIONAL SALES CORPORATION LEGISLATION, 1974 ANN. REP. (1976), for the most well-known example of such a study. The report was assailed from all sides. *See, e.g.*, LIBRARY OF CONGRESS, CONGRESSIONAL RESEARCH SERVICE, THE DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) PROVISION AND ITS EFFECT ON EXPORTS AND UNEMPLOYMENT: A BACKGROUND REPORT (1976); Sunley, *DISC, Exports, and Jobs: A Misuse of the Numbers*, 4 TAX NOTES No. 19, at 5 (1976). The DISC Report, *supra* note 14, which was issued in 1977, stands in striking contrast to the earlier study.

It is important that the Treasury staff reassume its position of influence in Congress. Specifically, in regard to tax simplification, the Treasury should be required to develop, articulate, and educate both the Congress and the general public on the consistent and principled pathways that can lead to tax simplification. Moreover, the President must effectively support the Treasury positions if the Treasury influence in Congress is to be optimized. Unhappily, the Treasury staff that assumed office in 1977 was, at the outset, put in an unfortunate position by the energy tax proposals submitted by the Carter administration. Those proposals included a significant number of new tax expenditures, all of which moved in the direction of tax complexity rather than tax simplification. As has been noted earlier, these proposals were largely developed outside the Treasury and without Treasury influence or input. After the proposals were submitted to Congress, however, the responsibility for defending these new tax expenditures was then delegated to the Treasury staff. It was forced to advocate the new tax expenditures before Congress, despite the fact that the proposals ran directly counter to the tax simplification and tax reform themes being propounded by the Treasury and by the administration itself.

Constructive cooperation between the Treasury staff and the Joint Committee staff is likewise necessary for the achievement of tax simplification. Especially in the mark-up sessions by the tax-writing committees, general agreement on tax proposals is essential between the Treasury and JCT staffs if the committees are to function effectively. In the 1971-1976 period, the JCT staff and the Treasury staff too frequently disagreed on tax proposals. When the two staffs are not in agreement, the tax-writing committees are put in the impossible position of having to make a judgment between the differing views of two sets of tax experts. This is not a situation out of which a simplified tax system is likely to emerge.

This is not to say that the JCT staff must always agree with Treasury recommendations. But if the Treasury staff is permitted to do its job properly, the number of instances in which the two tax staffs, working objectively, disagree should be minimized. If the requisite cooperation exists, the legislation that emerges from the tax-writing committees should be more rational and coherent. In other words, although broad areas of agreement between the Treasury and the JCT staffs will not ensure that the committees will move toward tax simplification, disagreement between the two staffs will almost surely produce unnecessary complexity.

Staffs of the Tax-Writing Committees. The staffs of the House Ways and Means Committee and the Senate Finance Committee have not traditionally played major substantive roles in the development of tax legislation. In both instances, the Committee staffs perform primarily ministerial functions within the tax legislative process, such as arranging hearings, establishing timetables for witnesses, and the like. These functions can, of course, have an influence on the tax legislative process itself, but it is fair to say that the influence of the committee staffs on tax legislative proposals is far less than that of the Joint Committee staff.

Nontax Staff Influences. Staff members other than those on staffs directly concerned with tax legislation may also play important roles in the tax legislative process. When the House Ways and Means Committee considered the legislation that became the Tax Reform Act of 1976, some Democratic members of the committee jointly employed tax experts to serve as their specific staff resource, outside the JCT staff, on the tax reform proposals being considered by the Committee. After the Tax Reform Act was enacted, however, these staff personnel departed. For various reasons, the practice has not been reinstituted by members of the Ways and Means Committee.

As a result of the revised budget processes that were instituted in 1974, as discussed previously, the staffs of the House Budget Committee and the Senate Budget Committee have developed a considerable tax expertise. The influence of these staff members is, of course, especially important, as Budget Committee members take positions on tax expenditure issues both individually and as Committees. Similarly, the staff of the Congressional Budget Office includes a Director of Tax Policy, who has the responsibility for tax expenditures. Both the staff of the Congressional Budget Office and the staffs of the Senate and House Budget Committees have moved somewhat cautiously into the tax legislative arena. This caution reflects the developing and as yet uncertain role of the Budget Committees with respect to tax expenditures. Nonetheless, useful studies have begun to appear from the Budget Committee staffs.[71] As the roles of the budget process, the

[71] The Congressional Budget Office publishes annually five-year budget projections, which include a supplement on tax expenditures. The latest in the series is FIVE-YEAR BUDGET PROJECTIONS: FISCAL YEARS 1978-1982 (1977). The most extensive analysis of a tax expenditure program undertaken by the CBO is REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES (1977). In addition, in March 1977, the CBO made a detailed study of proposed tax credits for college tuition costs for the use of the Senate Budget Committee.

The Senate Budget Committee Staff issued a useful compendium, TAX EXPENDITURES, 94th Cong., 2d Sess. (Comm. Print 1976). *See also* STAFF OF THE HOUSE BUDGET COMM., AN ANALYSIS OF DOMESTIC INTERNATIONAL SALES CORPORATIONS, 94th Cong., 2d Sess. (1975).

Budget Committees, and the Congressional Budget Office in the tax legislative process become more clearly defined, the influence of the Budget staffs on tax legislation can be expected to increase.

In addition, staff personnel located in various other offices become involved in particular aspects of the tax legislative process. Thus the Congressional Research Service of the Library of Congress includes several economists and lawyers who conduct tax policy research at the request of members of the Senate and House. The reputation of this staff within the Congress is high both because of the quality of the work products that have emerged to date on tax issues and because the reports are issued in a form that is readily usable by Senators and Congressmen in floor debate on tax legislative proposals.[72]

Similarly, the staff of the Joint Economic Committee has issued studies on tax policy, including specific analyses of various tax expenditures.[73]

As the tax expenditure concept has become more widely accepted and understood, the staffs of other substantive committees have developed an interest in and expertise with respect to the tax expenditures that correspond to their substantive areas of direct interest. For example, the staff of the Subcommittee on Multinational Corporations within the Senate Foreign Relations Committee includes aides who have developed considerable knowledge of United States taxation of international business operations. The results of that staff interest have been reflected on the Senate floor, as the Chairman of the Subcommittee, Senator Church, has taken an active role in opposing existing tax expenditures for United States corporations operating abroad.[74]

A relatively new development has been the emergence of a staff that is capable of analyzing tax issues within the General Accounting Office. Although studies to date have focused largely on the administration of the tax laws by the Internal Revenue Service, the staff has been expanded and can be expected to implement studies on substantive tax issues.

[72] *See* U.S. Treas. Dep't, The Operation and Effect of the Domestic International Sales Corporation Legislation, 1974 Ann. Rep. (1976). *See also* Gourevitch, Integration of Corporate and Shareholder Taxes on Income: The European Experience (1977); Gravelle, Tax Provisions and Effective Tax Rates in the Oil and Gas Industry (1977); Tannenwald & Farb, Comparative Cost-Effectiveness of Alternative Investment Tax Incentives (1976).

[73] *See, e.g.*, the Joint Economic Committee staff study, Broadening the Ownership of New Capital: ESOP's and Other Alternatives (1976). *See also* 122 Cong. Rec. S. 12426 (daily ed. July 26, 1976) (statement of Senator Humphrey).

[74] 122 Cong. Rec. S. 10994 *ff.* (daily ed. June 29, 1976). On the other hand, these non-tax forces can needlessly and improperly complicate tax legislation as, for example, in the 1976 Act provisions denying the foreign tax credit for participation in an international boycott. I.R.C. § 908.

Individual Senators and Representatives may have particular aides who are acquainted with tax issues. In no case, however, can it presently be said that a Senator or Representative has consciously sought to add a tax expert as a member of his or her permanent staff. This simply reflects the fact that Senators and Representatives have limited staffs but almost unlimited subject matter responsibilities. It is virtually impossible to devote a major portion of a limited staff budget to an individual who is concerned solely with tax issues. The staffs of individual Senators and Congressmen do include persons who have gained considerable experience through working on tax bills. These individuals can play a very important role in the development of a position adopted by their Senator or Representative as tax legislation is considered on the House and Senate floors.

As the income tax system continues to be utilized for the mechanism of effecting federal spending programs, the influence of nontax staff personnel can be expected to grow apace. For example, in the Senate consideration of the Energy Tax Bill of 1977, the Senate Budget Committee staff utilized the services not only of its own tax personnel but also of staff individuals who were experts on substantive energy issues. Other individual Senators did the same. As the tax expenditure idea becomes more ingrained in the thinking of Senators and Representatives, this process can be expected to accelerate. There is, after all, little reason to turn to a tax expert for advice on a tax expenditure for housing rather than to a lawyer or economist who has developed expertise in studying housing problems as such.

As in the cases of the Congressional committees and the nontax departments of the executive branch, the existence of nontax personnel in the tax legislative process moves in both directions along the simplicity-complexity line. The presence of these individuals, each with their own interests, abilities, philosophies, and degree of tax training, makes the process more complex. On the other hand, the existence of substantive expertise in areas covered by tax expenditures is likely to produce more rational, efficient, and equitable spending programs within the tax system. This latter movement is in the direction of simplicity, at least in the sense of rationality.

External Factors Operative in the Tax Legislative Process

Thus far the institutional factors that operate within the tax legislative process have been considered. As has been seen, the various centers of political responsibility operate, to some extent, autonomously to

achieve specific objectives within the process. They also interact with each other. In turn, most of the institutional elements are influenced by factors external to the formal processes of government itself.

The Factor of Lobbyists. The massive influence exerted by lobbyists on tax legislation is almost entirely within the context of tax expenditure provisions. The hordes of lobbyists attracted by Congressional consideration of proposals to create, expand, limit, or repeal tax expenditure provisions virtually disappear when the tax-writing committees turn their attention to structural issues, such as changes in rates, personal exemptions, or the standard deduction (zero bracket amount).

Lobbyists representing beneficiaries of tax expenditures constitute a factor that, virtually without exception, propels the income tax system in the direction of greater complexity. Any efforts at simplification through repeal or reduction of an existing tax expenditure are met with a well-financed campaign portraying an apocalyptic vision of unemployment, unfavorable balance of payments or trade, weakened national security, energy dependence, or any other current economic problem if their client's particular tax subsidy is curtailed. On the other hand, passage of each proposed new tax expenditure is equally backed as the solution that the country has been waiting for to such problems as energy, pollution, the inner city, historic preservation, health, and so forth. The exclusive function of the special interest lobbyists is to protect or expand tax expenditures, which thereby increase the complexity of the tax system.

It can be said without fear of contradiction that no beneficiary of a tax expenditure will "call off" its lobbyists just because it is advised that their efforts are making the tax system more complicated. No beneficiary will quietly acquiesce in the repeal of its tax subsidy because the Treasury seeks a simpler tax system. The financial resources of the lobbyists involved in the tax legislative process are enormous, and the skills of the lobbyists are finely honed to exert pressure on each of the various elements of the tax legislative process with maximum impact.

Thus the road to tax simplification by repeal of tax expenditures will be a long and difficult one with many detours on the way. Is there any way to mobilize, neutralize, or defeat the lobbyist factor in tax simplification efforts directed at tax expenditures?

Some have suggested the creation of an extragovernmental commission on the order of the Carter Commission in Canada.[75] John S. Nolan, a former Treasury tax policy official, has presented the most detailed

[75] *See* Nolan, *supra* note 1, at 22; Roberts, *et al.*, *supra* note 1, at 334.

outline of how such a commission might function. He has recommended that the commission should develop and present to Congress over a period of six years a comprehensive set of proposals that would achieve a simpler and more equitable tax system. The essence of the proposal is that individual recommendations might be considered and acted upon only in light of their role in the projected overall system. It is safe to say that the system envisioned by Mr. Nolan would be widely accepted by those who have engaged in tax reform efforts.

The analysis of the above political factors suggests, however, that certain reservations should be entered in regard to the use of a blue ribbon commission to achieve a greatly simplified tax system. In the first place, approval of the new process for developing comprehensive tax revision proposals must be approved by the existing political process itself. Elements presently operative within that process who would see their influence or power diminished by or transferred to the proposed commission could be expected to marshall their political forces to oppose the idea.

Second, if the President and Congress were to approve the creation of the commission, the operation of all the elements in the present tax legislative process would be shifted to a different arena. The problems underlying tax complexity are, at bottom, political and can only be solved by a political process. Is there evidence to suggest that a blue ribbon commission would be better equipped to handle the political tug and pull that inevitably accompanies major tax legislative proposals than the executive and legislative branches of government? For example, the blue ribbon Commission on Private Philanthropy and Public Needs, after two years of work and the expenditure of several million dollars for in-depth studies of all aspects of the interaction between government and the charitable sector (especially as reflected in the tax system), produced only a resounding vote of confidence in the status quo. Lobbyists for a particular tax expenditure are equally unlikely to take extended vacations just because the fate of their subsidies is in the hands of a commission rather than the Treasury and Congress.

Finally, there is no tradition of political success for extragovernmental commissions in the United States. Such bodies, although familiar in countries with parliamentary traditions, do not evoke expectations of change within the United States citizenry.

Will the suggestions advanced earlier in this paper fare better in dealing with the power of the lobbies for tax expenditure beneficiaries? There are grounds for greater optimism if repeal, modification, or

transfer to direct programs of tax expenditures is approached via coordinated studies and proposals from within the executive branch. One advantage is that the influences of the Treasury and the nontax department in whose area a tax expenditure operates would be unified. At present, the lobbyists for particular tax expenditures can often enlist, openly or behind the scenes, the support of the nontax department. The unified forces of the executive branch tax and nontax departments would represent a more potent political element to oppose the power of the lobbies.

Another advantage is that Congress would not always be confronted with the option of having to vote either for tax simplification (reform) *or* for financial support for a particular interest or activity. When the lines are drawn in this fashion, the lobbying factor will inevitably be opposed to simplification. A different strategy could cause a realignment of the lobbying forces. Where the executive branch studies reveal the need for federal aid, simultaneous proposals could be submitted to shift the tax subsidies to more efficient and equitable direct programs. Congress then would have the option to vote for tax simplification (reform) *and* federal financial support for a particular activity or group. In such a situation, with careful preparation, the lobbying factor might even be a source of support for tax simplification. The gradual shifting between 1969 and 1977 of state and local government organizations from opposition to support of the taxable bond interest subsidy proposal provides some evidence that properly structured direct subsidy alternatives to tax expenditures can be attractive to the tax expenditure beneficiaries.

The suggested approach is not, of course, a "quick fix" formula for tax simplification. It involves a case-by-case approach to each tax expenditure provision. But it is a path toward tax simplification that can utilize the existing political process, rather than trying to circumvent it.

When revisions of structural areas of the income tax system are considered, a somewhat different set of lobbyists, including national, state, and local bar association groups and accountants' organizations, emerges. These groups and their members have issued periodic calls for tax simplification. Why have the pleas of the tax experts produced so little change? One reason, I suspect, is that the members of these same organizations are also those who counsel and testify on behalf of their clients' tax expenditures. In these efforts, one never hears a plea for tax simplification. Lawyers who have urged the repeal of the carryover basis provisions enacted in 1976 on the ground of excessive complexity

would, I predict, have been totally silent if the change involved had provided a sliding scale reduced rate of capital gains taxation (even though the 1930's experiment with such a system was repealed partly because of its complexity).

In short, tax lawyers and accountants have a credibility problem on the simplification issue because they have so closely identified themselves with the financial interests of their clients. It is more than a little ironic that the calls for simplification are most vigorously sounded by the very groups whose members exert their professional efforts on behalf of their clients to retain or expand the greatest cause of complexity in the tax system—the tax expenditure provisions.

The tax bar and tax accountants can play a major and constructive role in rationalizing the structural provisions necessary to apply an income tax to the complex commercial affairs with which lawyers and accountants are intimately familiar. The resources of these groups should be used if, as has been suggested earlier, the Treasury separates simplification of structural tax provisions from simplification of tax expenditure provisions. In the former area, the tax bar and tax accountants can constitute a part of an effective answer to tax complexity; in the latter area, they constitute part of the problem.

The Media. The news media exerts an important, though difficult to measure, influence on tax legislation. In some cases, the impact of news stories is clear. For example, in 1969 a story on the tax advantages of using appreciated property to redeem a corporation's own stock appeared in the daily newspapers during the Senate Finance Committee's mark-up sessions on the Tax Reform Act of 1969. Section 311(d) was the immediate result.

Usually, however, the impact of the news media is not directly translated into specific tax legislation. The necessity to use the vast educational potential of newspapers, periodicals, radio, and television in the cause of tax simplification, however, is apparent. By and large, this requires that, once the executive branch has developed a comprehensive approach to tax simplification that it is prepared to apply consistently, it must educate the taxpaying public through all the news media available. If movement toward tax simplification is to be achieved along the lines suggested in this paper, it will not be a simple process. It is therefore critical that the beneficiaries of simplification clearly perceive both the advantages of proposed changes and the methods adopted to produce the necessary changes. The news media represents the only effective educational tool by which the requisite public support can be engendered.

The Public Interest. In addition to the forces of well-financed, vested interests in tax expenditures, which are responsible for much of the tax complexity, there are counter forces operative in the tax legislative process. Sometimes, the dominance or the skillful use of one of the factors described previously in this paper reduces the scope of tax expenditures. In other cases, the result occurs automatically (accidentally?) because of the need to make structural revisions in the tax system. An increase in the zero bracket amount may be desired to provide tax reductions confined to low- and middle-income tax brackets. Reductions of the tax expenditures involved in the itemized personal deductions automatically result. Or the tax rates for the top brackets are reduced; again, an automatic reduction in tax expenditures effected through special deductions and exemptions is the result. In such cases, the beneficiaries of the tax expenditures may not perceive the adverse impact of the changes, or they are reluctant to publicly oppose popular tax cuts. Here, the "public interest" is clearly perceived and readily dramatized.

But the self-interest in modification or repeal of particular tax preferences is less clearly recognized by broad segments of the public. Thus public opinion is less easily mobilized as an effective factor for tax simplification. The rise in the 1970's of the "public interest" lobbies for tax reform has been an important development in the tax legislative process. For example, the Ralph Nader-sponsored Tax Reform Research Group has been increasingly effective not only as a lobbying force among other lobbyists but also as a mobilizing force behind local organizations by urging them to bring public opinion to bear on individual Senators or Representatives to back tax reform efforts. The ultimate influence of this factor, still in its formative stages, has yet to be determined.

CONCLUSION

The preceding survey of the political process within which tax legislation develops reveals a picture of extraordinary complexity. Although the discussion has focused on a depersonalized description of the elements operative in the process, it must be kept in mind that these elements are activated by hundreds of individuals, each with different powers, abilities, interests, philosophies, and energies; and these individual characters change from year to year. The marshaling of all the diverse elements and people into a political force capable of producing tax simplification is itself far from a simple task. Those seeking sim-

plification merely by declaring existing complexity intolerable are inevitably doomed to disappointment.

Moreover, the process itself is in a period of change. This is a complicating factor, although I believe that the direction of the change is toward a rational, and therefore more understandable, political mechanism for dealing with the principal source of tax complexity, the tax expenditure provisions.

But the above analysis of the political process suggests that more can be done to move the tax system toward greater simplicity:

(1) The structural components of the income tax system should be clearly identified and separated from the tax expenditure system.

(2) Simplification of the structural component of the income tax system involves considerations quite different from those involved in simplification of the tax expenditure component. Thus the strategies to achieve simplification within each component must be different.

(3) A determined effort should be undertaken in the executive branch, and primarily in the Treasury, (a) to institute the requisite studies to provide a rational framework for resolution of necessarily complex structural issues; (b) to commence with OMB a systematic and coordinated analysis of the tax expenditure component, with the objective of repealing unnecessary tax expenditures, converting necessary tax expenditure programs to direct expenditure systems, or making more equitable and efficient those programs that analysis reveals should be continued through the tax expenditure mechanism; and (c) to mobilize, immobilize, or neutralize, as needed, the political elements present in the tax legislative process that enhance or detract from simplification efforts.

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

December 27, 1977

Mr. John S. Nolan
Miller & Chevalier
1700 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Dear Jack:

Enclosed are the documents I mentioned to you on the telephone. The 1977 tax return forms show the number of taxpayers who utilized each line on their 1976 returns, except in those few cases where the information is from 1975. In those cases "(75)" appears after the number. I do not believe the other attachments need an explanation.

Sincerely yours,

Enclosures

Department of the Treasury Internal Revenue Service

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return 1977** | N.A. - NOT AVAILABLE

For the year January 1–December 31, 1977, or other taxable year beginning , 1977 ending , 19

Use IRS label. Otherwise, print or type.

First name and initial (if joint return, give first names and initials of both) | Last name | Your social security number

Present home address (Number and street, including apartment number, or rural route) | For Privacy Act Notice, see page 3 of Instructions. | Spouse's social security no.

City, town or post office, State and ZIP code | Occupation | Yours ▶ | Spouse's ▶

Presidential Election Campaign Fund ▶ Do you want $1 to go to this fund? 18,458,169 -33% | Yes | No
If joint return, does your spouse want $1 to go to this fund? | Yes | No
Note: Checking "Yes" will not increase your tax or reduce your refund.

Filing Status — Check Only One Box

1. Single 14,437,698 - 26%
2. Married filing joint return (even if only one had income) 37,153,703 - 66%
3. Married filing separately. If spouse is also filing, give spouse's social security number in the space above and enter full name here ▶ 1,004,600 - 2%
4. Unmarried Head of Household. Enter qualifying name ▶ 3,218,623 - 6% ..... See page 7 of Instructions
5. Qualifying widow(er) with dependent child (Year spouse died ▶ 19). See page 7 of Instructions

160,691*

Exemptions

Always check the "Yourself" box. Check other boxes if they apply.

6a Yourself | 65 or over | Blind
b Spouse | 65 or over | Blind

55,942,214 100% | 7,605,648 14% | 156,774 - 1/2%

Enter number of boxes checked on 6a and b ▶

c First names of your dependent children who lived with you ▶ 27,561,233 — 49% 6c and 6d

Enter number of children listed ▶

d Other dependents: (1) Name	(2) Relationship	(3) Number of months lived in your home.	(4) Did dependent have income of $750 or more?	(5) Did you provide more than one-half of dependent's support?

Enter number of other dependents ▶

7 Total number of exemptions claimed ... 55,942,214 - 100% ... Add numbers entered in boxes above ▶

Please Attach Copy B of Forms W-2 Here

Income

8	Wages, salaries, tips, and other employee compensation. (Attach Forms W-2. If unavailable, see page 5 of Instructions.)	8	46,881,928	84%
9	Interest income. (If over $400, attach Schedule B.)	9	35,828,050	64%
10a	Dividends (If over $400, attach Schedule B) 12,622,005 23% 10b less exclusion 12,205,785 22%, Balance ▶ (See pages 9 and 17 of Instructions)	10c	8,499,611	15%
	(If you have no other income, skip lines 11 through 20 and go to line 21.)			
11	State and local income tax refunds (does not apply if refund is for year you took standard deduction)	11	7,847,606	14%
12	Alimony received	12	286,176	1/2%
13	Business income or (loss) (attach Schedule C)	13	7,518,800	13%
14	Capital gain or (loss) (attach Schedule D)	14	7,618,464	14%
15	50% of capital gain distributions not reported on Schedule D	15	891,324	2%
16	Net gain or (loss) from Supplemental Schedule of Gains and Losses (attach Form 4797)	16	1,[illegible]3,368	2%
17	Fully taxable pensions and annuities not reported on Schedule E	17	4,111,430	7%
18	Pensions, annuities, rents, royalties, partnerships, estates or trusts, etc. (attach Schedule E)	18	10,949,542	20%
19	Farm income or (loss) (attach Schedule F)	19	2,810,218	5%
20	Other (state nature and source—see page 9 of Instructions) ▶	20	3,475,722	6%
21	Total income. Add lines 8, 9, and 10c through 20 ▶	21	N.A.	

Adjustments to Income *(If none, skip lines 22 through 27 and enter zero on line 28.)*

22	Moving expense (attach Form 3903)	22	1,[illegible]2,193	(75	2%
23	Employee business expenses (attach Form 2106)	23	5,311,774	(75	9%
24	Payments to an individual retirement arrangement (from attached Form 5329, Part III)	24	1,623,104		3%
25	Payments to a Keogh (H.R. 10) retirement plan	25	595,892	(75	1%
26	Forfeited interest penalty for premature withdrawal	26	177,466	(75	1/2%
27	Alimony paid (see page 11 of Instructions)	27	N.A.		

28	Total adjustments. Add lines 22 through 27 ▶	28	8,393,[illegible]	15%
29	Subtract line 28 from line 21	29	N.A.	
30	Disability income exclusion (sick pay) (attach Form 2440)	30	350,070	1/2%
31	Adjusted gross income. Subtract line 30 from line 29. Enter here and on line 32. If you want IRS to figure your tax for you, see page 4 of the Instructions ▶	31	55,942,214	100%

Please Attach Check or Money Order Here

Form 1040 (1977) Page **2**

Tax Computation	32	Amount from line 31			32	[illegible]42,214	100%
	33	If you itemize deductions, enter excess itemized deductions from Schedule A, line 41. If you do NOT itemize deductions, enter zero . . TOTAL DEDUCTIONS **Caution:** *If you have unearned income and can be claimed as a dependent on your parent's return, check here* ▶ ☐ *and see page 11 of the Instructions. Also see page 11 of the Instructions if:* ● You are married filing a separate return and your spouse itemizes deductions, OR ● You file Form 4563, OR ● You are a dual-status alien.			33	55,425,504	99%
	34	Tax Table Income. Subtract line 33 from line 32 . . . . TAXABLE INCOME **Note:** See Instructions for line 35 on page 11. Then find your tax on the amount on line 34 in the Tax Tables. Enter the tax on line 35. However, if line 34 is more than $20,000 ($40,000 if you checked box 2 or 5) or you have more exemptions than those covered in the Tax Tables for your filing status, use Part I of Schedule TC (Form 1040) to figure your tax. You must also use Schedule TC if you file Schedule G (Form 1040), Income Averaging.			34	49,003,038	87 1/2%
	35	Tax. Check if from ☐ Tax Tables or ☐ Schedule TC . . . 3,110 . . . 145,889			35	[illegible]	[illegible]
	36	Additional taxes. (See page 12 of Instructions.) Check if from ☐ Form 4970, ☐ Form 4972, ☐ Form 5544, ☐ Form 5405, or ☐ Section 72(m)(5) penalty tax 15 41 N.A.			36	N.A.	
	37	**Total.** Add lines 35 and 36 ▶			37	[illegible]	[illegible] 1/2%
Credits	38	Credit for contributions to candidates for public office	38	1,030,483	3[illegible]		
	39	Credit for the elderly (attach Schedules R&RP)	39	1,011,6[illegible]	[illegible]		
	40	Credit for child and dependent care expenses (attach Form 2441)	40	2,658,4[illegible]	4 1/2%		
	41	Investment credit (attach Form 3468)	41	3,310,02[illegible]	6 1/2%		
	42	Foreign tax credit (attach Form 1116)	42	240,898	1/2%		
	43	Work Incentive (WIN) Credit (attach Form 4874)	43	5,702			
	44	New jobs credit (attach Form 5884)	44	N.A.			
	45	See page 12 of Instructions	45	N.A.			
	46	**Total credits.** Add lines 38 through 45			46	N.A.	
	47	**Balance.** Subtract line 46 from line 37 and enter difference (but not less than zero) ▶			47	46,842,827	84%
Other Taxes	48	Self-employment tax (attach Schedule SE)			48	7,140,736	13%
	49	Minimum tax. Check here ▶ ☐ and attach Form 4625			49	246,441	1/2%
	50	Tax from recomputing prior-year investment credit (attach Form 4255)			50	549,096	1%
	51	Social security tax on tip income not reported to employer (attach Form 4137)			51	72,697	1/2%
	52	Uncollected employee social security tax on tips (from Form W-2)			52	4,670	
	53	Tax on an individual retirement arrangement (attach Form 5329)			53	N.A.	
	54	**Total tax.** Add lines 47 through 53 ▶			54	N.A.	
Payments	55	Total Federal income tax withheld (attach Forms W-2, W-2G, and W-2P to front)	55	45,339,104	81[illegible]		
	56	1977 estimated tax payments (include amount allowed as credit from 1976 return)	56	2,472,253	4 1/2%		
	57	Earned income credit. If line 31 is under $8,000, see page 2 of Instructions. If eligible, enter child's name ▶	57	2,962,085	6[illegible]		
	58	Amount paid with Form 4868	58	315,280	1/2%		
	59	Excess FICA and RRTA tax withheld (two or more employers)	59	1,721,006	3[illegible]		
	60	Credit for Federal tax on special fuels, etc. (attach Form 4136)	60	1,603,924	3[illegible]		
	61	Credit from a Regulated Investment Company (attach Form 2439)	61	14,829	(73)		
	61a	See page 13 of Instructions	61a	N.A.			
	62	**Total.** Add lines 55 through 61a ▶			62	N.A.	
Refund or Due	63	If line 62 is larger than line 54, enter amount **OVERPAID** ▶			63	38,097,416	68%
	64	Amount of line 63 to be **REFUNDED TO YOU** ▶			64	36,512,965	65%
	65	Amount of line 63 to be credited on 1978 estimated tax ▶	65	2,472,253	4 1/2%		
	66	If line 54 is larger than line 62, enter **BALANCE DUE.** Attach check or money order for full amount payable to "Internal Revenue Service." Write social security number on check or money order ▶ (Check ▶ ☐ if Form 2210 (2210F) is attached. See page 14 of Instructions.)			66	15,447,206	28[illegible]

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature Date

▶ Spouse's signature (if filing jointly, BOTH must sign even if only one had income)

▶ Paid preparer's signature and identifying number (see instructions)

▶ Paid preparer's address (or employer's name, address, and identifying number)

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Schedules A&B—Itemized Deductions AND Interest and Dividend Income

(Form 1040)
Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

1977

Name(s) as shown on Form 1040 | Your social security number

Schedule A Itemized Deductions (Schedule B is on back)

Medical and Dental Expenses (not compensated by insurance or otherwise) (see page 14 of Instructions)

1 One-half (but not more than $150) of insurance premiums for medical care. (Be sure to include in line 10 below)	[illegible] (75)	
2 Medicine and drugs	[illegible] (75)	
3 Enter 1% of line 31, Form 1040	[illegible] (75)	
4 Subtract line 3 from line 2. Enter difference (if less than zero, enter zero)	[illegible] (75)	
5 Enter balance of insurance premiums for medical care not entered on line 1	[illegible] (75)	
6 Enter other medical and dental expenses:		
a Doctors, dentists, nurses, etc.		
b Hospitals		
c Other (itemize—include hearing aids, dentures, eyeglasses, transportation, etc.) ▶	14,751,661 (75)	
7 Total (add lines 4 through 6c)	16,271,942 (75)	
8 Enter 3% of line 31, Form 1040	[illegible] (75)	
9 Subtract line 8 from line 7 (if less than zero, enter zero)	11,954,814 (75)	
10 Total (add lines 1 and 9). Enter here and on line 33 ▶	19,042,687	

Taxes (See page 14 of Instructions.)

11 State and local income	21,131,908 (75)	
12 Real estate	22,104,369 (75)	
13 State and local gasoline (see gas tax tables)	24,557,076 (75)	
14 General sales (see sales tax tables)	25,022,426 (75)	
15 Personal property	[illegible] (75)	
16 Other (itemize) ▶	3,074,170 (75)	
17 Total (add lines 11 through 16). Enter here and on line 34 ▶	25,317,344	

Interest Expense (See page 16 of Instructions.)

18 Home mortgage	19,213,032	
19 Other (itemize) ▶		
20 Total (add lines 18 and 19). Enter here and on line 35 ▶	[illegible]	

Contributions (See page 16 of Instructions for examples.)

21 a Cash contributions for which you have receipts, cancelled checks or other written evidence b Other cash contributions. List donees and amounts ▶	24,539,019 (75)	
22 Other than cash (see page 16 of instructions for required statement)	4,152,200 (75)	
23 Carryover from prior years	61,057 (75)	
24 Total contributions (add lines 21a through 23). Enter here and on line 36 ▶	24,404,446	

Casualty or Theft Loss(es) (See page 16 of Instructions.)

25 Loss before insurance reimbursement		
26 Insurance reimbursement		
27 Subtract line 26 from line 25. Enter difference (if less than zero, enter zero)		
28 Enter $100 or amount on line 27, whichever is smaller		
29 Casualty or theft loss (subtract line 28 from line 27). Enter here and on line 37 ▶	1,988,457	

Miscellaneous Deductions (See page 16 of Instructions.)

30 Union dues	8,735,732 (75)	
31 Other (itemize) ▶		
POLITICAL CONTRIBUTIONS	687,571 (75)	
32 Total (add lines 30 and 31). Enter here and on line 38 ▶	21,514,789	

Summary of Itemized Deductions (See page 17 of Instructions.) **A**

33 Total medical and dental—line 10		
34 Total taxes—line 17		
35 Total interest—line 20		
36 Total contributions—line 24		
37 Casualty or theft loss(es)—line 29		
38 Total miscellaneous—line 32		
39 **Total deductions** (add lines 33 through 38) ▶		
40 If you checked Form 1040, box: 2 or 5, enter $3,200 1 or 4, enter $2,200 3, enter $1,600		
41 **Excess itemized deductions** (subtract line 40 from line 39). Enter here and on Form 1040, line 33. (If line 40 is more than line 39 see "Who MUST Itemize Deductions" on page 11 of the Instructions.) ▶		

Form **1040A** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1977**

Use IRS label. Otherwise, print or type.

First name and initial (if joint return, give first names and initials of both) | Last name | Your social security number

Present home address (Number and street, including apartment number, or rural route) | For Privacy Act Notice, see page 9 of Instructions. | Spouse's social security no.

City, town or post office, State and ZIP code | Occupation: Yours ▶ Spouse's ▶

Presidential Election Campaign Fund ▶ Do you want $1 to go to this fund?. 8,917,265 . . . Yes | N.A. No
If joint return, does your spouse want $1 to go to this fund? Yes | N.A. No
Note: Checking "Yes" will not increase your tax or reduce your refund.

Filing Status

Check Only One Box

1 ☐ Single 18,389,937 - 64%
2 ☐ Married filing joint return (even if only one had income) 7,231,606 - 25%
3 ☐ Married filing separately. If spouse is also filing, give spouse's social security number in the space above and enter full name here ▶ 869,296 - 3%
4 ☐ Unmarried Head of Household. Enter qualifying name ▶ 2,069,989 - 7%. See page 6 of Instructions.

Exemptions

Always check the "Yourself" box. Check other boxes if they apply.

5a ☐ Yourself ☐ 65 or over ☐ Blind
b ☐ Spouse ☐ 65 or over ☐ Blind
28,593,929 100% | 379,201 1% | 19,658
Enter number of boxes checked on 5a and b ▶ ☐

c First names of your dependent children who lived with you ▶ 7,678,654 - 27%
Enter number of children listed ▶ ☐

d Other dependents: (1) Name	(2) Relationship	(3) Number of months lived in your home	(4) Did dependent have income of $750 or more?	(5) Did you provide more than one half of dependent's support?

Enter number of other dependents ▶ ☐

Add numbers entered in boxes above ▶ ☐

6 Total number of exemptions claimed 28,593,929 - 100%. . . . .

Please Attach Copy B of Forms W-2 Here

7	Wages, salaries, tips, and other employee compensation. (Attach Forms W-2. If unavailable, see page 11 of Instructions)			28,536,388	100%
8	Interest income (see page 4 of Instructions)			6,756,783	24%
9a	Dividends 950,983 3% 9b Less exclusion 785,519 3% Balance ▶ (See pages 4 and 11 of Instructions)			9c 526,160	[illegible]
10	Adjusted gross income (add lines 7, 8, and 9c). If under $8,000, see page 2 of Instructions on "Earned Income Credit." If eligible, enter child's name ▶			[illegible]8,593,929	100%
11a	Credit for contributions to candidates for public office. Enter one half of amount paid but do not enter more than $25 ($50 if joint return)	11a	713,712	3[illegible]	
	IF YOU WANT IRS TO FIGURE YOUR TAX, PLEASE STOP HERE AND SIGN BELOW.				
b	Total Federal income tax withheld (if line 7 is larger than $16,500, see page 12 of Instructions)	11b	27,894,281	9[illegible]	
c	(97,588 returns with excess FICA) Earned income credit (from page 2 of Instructions)	11c	2,995,520	11[illegible]	
12	Total (add lines 11a, b, and c)			N.A.	
13	Tax on the amount on line 10. (See Instructions for line 13 on page 12, then find your tax in Tax Tables on pages 14–25.)			19,646,541	68%
14	(NOT included are 41,073 returns with ONLY a credit on 1977 Tax) If line 12 is larger than line 13, enter amount to be REFUNDED TO YOU ▶			26,666,769	93%
15	If line 13 is larger than line 12, enter BALANCE DUE. Attach check or money order for full amount payable to "Internal Revenue Service." Write social security number on check or money order ▶			1,510,212	5 1/2%

Please Attach Check or Money Order Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Please Sign

▶ Your signature Date

▶ Spouse's signature (if filing jointly, BOTH must sign even if only one had income)

▶ Paid preparer's signature and identifying number (see Instructions)

▶ Paid preparer's address (or employer's name, address, and identifying number)

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S

Internal Revenue Service Data Regarding Use of 1976 Income Tax Forms

ERRORS ON INDIVIDUAL INCOME TAX RETURNS

General Comments

The Internal Revenue Service engages in a variety of publicity efforts emphasizing the most common taxpayer errors. Our experience indicates that new tax laws and resulting changes to the tax return cause an increase in errors. Ideally, the best way to reduce taxpayer errors is to minimize changes. It is also important to simplify tax laws (e.g., the use of flat amounts rather than percentages). Whenever the taxpayer is given alternatives, doubt is created, and more errors occur. For example, instructions which say to take the highest or lowest amount make the returns very complex for people who are not normally accustomed to using numbers.

Error rates are constantly monitored by the Service during the filing season. Using reports, statements, analyses, and field visitations, we develop plans to correct deficiencies and transmit these to the public and our field personnel. Special programs are developed to insure the smooth implementation of changes required by new tax laws.

On errors caused by other than tax law changes, the greatest number occur when taxpayers are asked to add or subtract two figures or are asked to transfer an amount from one line to another or from one form to another. (Other typical errors include use of incorrect tax tables, claiming incorrect filing status, multiplication errors, etc.)

Errors by Type of Preparer

Data in the following charts show a higher incidence of errors on Forms 1040 than on Forms 1040A, confirming that the potential for errors increases with the complexity of the tax return. Further, as the

following indicates, the greatest frequency of error occurs when taxpayers prepare their own returns:

Type of Preparer	Error Rate [1] Form 1040	Error Rate [1] Form 1040A
IRS	4.8	2.4
Third Party	6.3	7.6
VITA	13.0	10.4
Taxpayer	15.2	13.4

Taxpayers make more errors because they generally are less familiar with the basic requirements and they are less likely to be aware of the impact of new tax legislation. The rate of errors usually will decrease when requirements do not change significantly from one year to the next.

We believe that provisions of the Tax Reduction and Simplification Act of 1977 will significantly reduce errors over time. Eliminating computations for the general tax credit, standard deduction, and, for most taxpayers, tax due will remove the source of three of the most frequent errors. There may be some first-year confusion, however, as taxpayers will be unfamiliar with the newly developed tax tables which incorporate these computations.

Chart I
Form 1040 Errors by Type of Preparer [a]

January 1—September 30, 1977
Order of Frequency of Six Most Common Errors [b]

Type of Preparer	Number of 1040's Prepared	No. of Returns With Error(s)	Error Rate	Gen. Tax Cr.	Tax	Computation of: Std. Ded.	Computation of: Med. Ded.	Computation of: EIC	Overpy./ Bal. Due
Third Pty.	35,563,435	2,235,150	6.3	1	2	3	5	4	6
Taxpayer	18,159,033	2,761,294	15.2	1	2	4	3	[c]	5
IRS	145,609	6,960	4.8	2	3	4	[d]	1	6
Volunteer Income Tax Assister	42,675	5,566	13.0	1	3	4	5	2	[e]

[a] The errors in this table represent 78% of all the errors made on Forms 1040.
[b] 1 is the highest level of frequency.
[c] Not among top six taxpayer errors. Sixth most common error is itemized vs. standard deduction.
[d] Fifth most frequent IRS error was on the Credit for the Elderly, Schedules R&RP.
[e] Sixth most common error is Schedules R&RP.

[1] $\frac{\text{No. of returns with errors}}{\text{No. of returns prepared}} = \text{Error rate}$

Chart II

Form 1040A Errors by Type of Preparer[1]

January 1—September 30, 1977
[2] Order of Frequency of Five Most Common Errors

Type of Preparer	Number of 1040's Prepared	Number of Returns With Errors	Error Rate	Gen. Tax Cr.	Computation of: Tax	Std. Ded.	EIC	Overpy./ Bal. Due
[3] Third Pty.	5,827,553	445,732	7.6	1	3	2	4	5
[4] Taxpayer	22,146,714	2,972,684	13.4	1	3	2	6	4
IRS	572,550	13,530	2.4	1	4	2	3	5
[5] VITA	121,782	12,600	10.4	2	5	3	1	4

[1] The errors in this table represent 92% of all the errors made on Forms 1040A.
[2] 1 is the highest level of frequency.
[3] Third Party includes returns signed by person in addition to taxpayer(s).
[4] Fifth most common error made by taxpayers related to Excess FICA/RRTA.
[5] Volunteer Income Tax Assister.

Most Common Taxpayer Errors on Returns Filed in 1977[1]

Error Condition	Number of Taxpayer Errors Through September 30, 1977 Form 1040	Form 1040A
1. Miscalculating the standard deduction.	663,941	908,159
Taxpayers were not required to compute the standard deduction on every return prior to 1976. Next year taxpayers will be able to use a flat rate rather than a percentage, and we feel that errors in this area should drop substantially.		
2. Calculating the general tax credit improperly. (This was called personal exemption credit in previous years.)	1,207,702	997,968
Two calculations had to be made by the taxpayer as opposed to one calculation for the prior year. Next year most taxpayers will not have to do this, since it will be built into the tables. Only		

[1] Total 1040 returns filed 53,910,752.
Total 1040A returns filed 28,668,599.

	Number of Taxpayer Errors Through September 30, 1977 Form 1040	Form 1040A
high-income taxpayers and taxpayers with special tax computations (*i.e.,* Schedule G, etc.) will have to compute this credit.		
3. Calculating the earned income credit.	394,671	523,750
In addition to failing to compute correctly, some taxpayers failed to take advantage of this credit, and others failed to substantiate it.		
4. Computation of tax using taxable income rather than adjusted gross income as in previous years.	718,767	388,848
The tax tables are being changed again for 1977 so that the taxpayer will not have to compute taxable income.		

Errors by Line Item on Form 1040

The following form shows the number of significant errors by line item made on 1976 tax returns processed through September 30, 1977.* Lines marked with the symbols ♦ or ≪ are explained below:

♦ These entries have been eliminated due to the design of the 1977 returns or tax legislation. They are built into the new tax tables for the 1977 Form 1040A, and taxpayers will not have to make any computations.

≪ For most taxpayers, computation of these items has been built into the tax tables for tax year 1977.

Blank lines on the following return indicate either that there were no math errors or that the count was so low that it was not significant.

* EDITOR'S NOTE: Tax Form 1040A for 1976 was included with the materials distributed at the Federal Income Tax Simplification Conference, but was not available for reproduction at the time this volume was printed.

1040 Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** **1976** | This space for IRS use only

For the year January 1–December 31, 1976, or other taxable year beginning , 1976 ending , 19

Please print or type

Name (If joint return, give first names and initials of both) | Last name | Your social security number

Present home address (Number and street, including apartment number, or rural route) | For Privacy Act Notification, see page 5 of Instructions | Spouse's social security no

City, town or post office, State and ZIP code | Occupation: Yours ▶ Spouse's ▶

Filing Status

1 Single 72751 (Check only ONE box)

INCONSISTENCY BETWEEN FILING STATUS
CHECKED AND OTHER INFORMATION ON RETURN

to see if you qualify ▶

5 ☐ Qualifying widow(er) with dependent child (Year spouse died ▶ 19) See page 7 of Instructions

6a Regular ☐ Yourself ☐ Spouse — Enter number of boxes checked ▶

b First names of your dependent children who lived with you — Enter number ▶

c Number of other dependents (from line 7) ▶

d Total (add lines 6a, b, and c) ▶

e Age 65 or older ☐ Yourself ☐ Spouse — Enter number of boxes checked ▶
Blind ☐ Yourself ☐ Spouse

f TOTAL (add lines 6d and e) 57,595 ▶

7 Other dependents (a) Name	(b) Relationship	(c) Months lived in your home. If born or died during year, write B or D	(d) Did dependent have income of $750 or more?	(e) Amount furnished for dependent's support: By YOU. If 100% write ALL	By OTHERS including dependent
				$	$

8 Presidential Election Campaign Fund ▶ Do you wish to designate $1 of your taxes for this fund? Yes No
If joint return, does your spouse wish to designate $1? Yes No
Note: If you check the "Yes" box(es) it will not increase your tax or reduce your refund.

Income — Please attach Copy B of Forms W-2 here

9	Wages, salaries, tips, and other employee compensation (Attach Forms W-2. If unavailable, see page 6 of Instructions.)	9	
10a	Dividends (see pages 9 and 15 of Instructions) . 10b less exclusion . Balance ▶ (If gross dividends and other distributions are over $400, list in Part I of Schedule B.)	10c	[illegible],721
11	Interest income. (If $400 or less, enter total without listing in Schedule B. If over $400, enter total and list in Part II of Schedule B.)	11	
12	Income other than wages, dividends, and interest (from line 37)	12	43,331
13	Total (add lines 9, 10c, 11 and 12)	13	100,358
14	Adjustments to income (such as moving expense, etc. from line 42)	14	2,470
15a	Subtract line 14 from line 13	15a	18,526
b	Disability income exclusion (sick pay) (attach Form 2440)	15b	9,258
c	**Adjusted gross income.** Subtract line 15b from line 15a, then complete Part III on back. (If less than $8,000, see page 2 of Instructions on "Earned Income Credit.")	15c	8,857

Tax, Payments and Credits — Please attach Check or Money Order here

16	Tax, check if from: ☐ Tax Table ☐ Schedule G ☐ Tax Rate Schedule X, Y or Z ☐ Form 2555 OR ☐ Schedule D ☐ Form 4726	16	718,767
17a	Multiply $35.00 by the number of exemptions on line 6d 12,034 — 17a		
b	Enter 2% of line 47 but not more than $180 ($90 if box 3 is checked) — 17b — Enter larger of a or b (If box on line 3 is checked see page 1[illegible] of Instructions)	17c	1,207,702
18	Balance. Subtract line 17c from line 16 and enter difference (but not less than zero)	18	84,624
19	Credits (from line 54)	19	18,503
20	Balance. Subtract line 19 from line 18 and enter difference (but not less than zero)	20	15,337
21	Other taxes (from line 62)	21	15,785
22	Total (add lines 20 and 21)	22	20,891
23a	Total Federal income tax withheld (attach Forms W-2, or W-2P to front)	23a	74,878
b	1976 estimated tax payments (include amount allowed as credit from 1975 return)	23b	
c	Earned income credit (from page 2 of Instructions)	23c	394,671
d	Amount paid with Form 4868	23d	
e	Other payments (from line 66)	23e	11,163
24	**TOTAL** (add lines 23a through e) ▶	24	23,561

Pay amount on line 25 in full with this return. Write social security number on check or money order and make payable to Internal Revenue Service.

Due or Refund

25	If line 22 is larger than line 24, enter **BALANCE DUE IRS** ▶ (Check here ▶ ☐, if Form 2210 or Form 2210F is attached. See page 10 of instructions.)	25	225,753
26	If line 24 is larger than line 22, enter amount **OVERPAID** ▶	26	
27	Amount of line 26 to be **REFUNDED TO YOU** ▶	27	
28	Amount of line 26 to be credited on 1977 estimated tax ▶	28	

Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Your signature — Date | ▶ Preparer's signature (and employer's name, if any) — Date

▶ Spouse's signature (if filing jointly, BOTH must sign even if only one had income) | ▶ Identifying number (see instructions) — Address (and ZIP code)

ATTACHMENT 3.1

Form 1040 (1976) Page 2

Part I Income other than Wages, Dividends and Interest

29	Business income or (loss) (attach Schedule C)	29	70,246
30a	Net gain or (loss) from sale or exchange of capital assets (attach Schedule D)	30a	111,[illegible]
b	50% of capital gain distributions (not reported on Schedule D—see page 10 of Instructions)	30b	
31	Net gain or (loss) from Supplemental Schedule of Gains and Losses (attach Form 4797)	31	
32a	Pensions, annuities, rents, royalties, partnerships, estates or trusts, etc. (attach Schedule E)	32a	29,764
b	Fully taxable pensions and annuities (not reported on Schedule E—see page 10 of Instructions)	32b	
33	Farm income or (loss) (attach Schedule F)	33	17,478
34	State income tax refunds (does not apply if refund is for year in which you took the standard deduction—others see page 10 of Instructions)	34	
35	Alimony received	35	
36	Other (state nature and source—see page 11 of Instructions) ▶	36	
37	**Total** (add lines 29 through 36). **Enter here and on line 12** ▶	37	[illegible]

Part II Adjustments to Income

38	Moving expense (attach Form 3903)	38	
39	Employee business expense (attach Form 2106)	39	
40a	Payments to an individual retirement arrangement from attached Form 5329, Part III	40a	
b	Payments to a Keogh (H.R. 10) retirement plan	40b	
41	Forfeited interest penalty for premature withdrawal (see page 12 of Instructions)	41	
42	**Total** (add lines 38 through 41). **Enter here and on line 14** ▶	42	

Part III Tax Computation

43	Adjusted gross income (from line 15c). If you have unearned income and can be claimed as a dependent on your parent's return, check here ▶ ☐ and see page 9 of Instructions	43	72,417
44a	If you itemize deductions, check here ▶ ☐, and enter total from Schedule A, line 40, and attach Schedule A		
b	Standard deduction—If you do not itemize deductions, check here ▶ ☐, and: 660,885 If you checked the box on line: 2 or 5, enter the greater of $2,100 OR 16% of line 43—but not more than $2,800 1 or 4, enter the greater of $1,700 OR 16% of line 43—but not more than $2,400 3, enter the greater of $1,050 OR 16% of line 43—but not more than $1,400	44	663,941
45	Subtract line 44 from line 43 and enter difference (but not less than zero)	45	73,772
46	Multiply total number of exemptions claimed on line 6f by $750	46	55,430
47	Taxable income. Subtract line 46 from line 45 and enter difference (but not less than zero)	47	63,096

- If line 47 is $20,000 or less and you did not average your income on Schedule G, or figure your tax on Form 2555, Exemption of Income Earned Abroad, find your tax in Tax Table. Enter tax on line 16 and check appropriate box
- If line 47 is more than $20,000, figure your tax on the amount on line 47 by using Tax Rate Schedule X, Y, Z, or if applicable, the alternative tax from Schedule D, income averaging from Schedule G, tax from Form 2555 or maximum tax from Form 4726. Enter tax on line 16 and check appropriate box

Part IV Credits

48	Credit for the elderly (attach Schedules R & RP)	48	66,295
49	Credit for child care expenses (attach Form 2441)	49	46,784
50	Investment credit (attach Form 3468)	50	
51	Foreign tax credit (attach Form 1116)	51	
52	Contributions to candidates for public office credit (see page 12 of Instructions)	52	20,344
53	Work Incentive (WIN) Credit (attach Form 4874)	53	
54	**Total** (add lines 48 through 53). **Enter here and on line 19** ▶	54	1,858

Part V Other Taxes

55		55	
56		56	
57	F 1040 9/30/77	57	
58		58	
59	TOTAL MATH ERRORS 5,007,970 1/	59	
60		60	
61	TOTAL RETURNS 53,910,752	61	
62	**Total** (add lines 55 through 61). **Enter here and on line 21** ▶	62	1,961

Part VI Other Payments

63	1/ This number represents the nubmer of returns with math errors.	63	56,578
64	The sum of all line items will exceed this figure because some	64	8,152
65	returns have more than 1 error.	65	
66		66	615

U.S. GOVERNMENT PRINTING OFFICE : 1976—O-218-395 23-0916750

Significant Taxpayer Errors on Returns Filed in 1977[1]

Form 1040 Error Condition	Number of Taxpayer Errors Through September 30, 1977
1. An error was made in computing Overpayment or Balance Due.	255,753
2. An error was made in addition of Itemized Deductions on Schedule A.	660,885
3. An error was made in arriving at Total Income on Line 13.	100,358
4. An error was made on Line 18 in subtracting the General Tax Credit from Line 16, Tax.	84,624
5. An error was made in figuring Income Averaging on Schedule G.	112,084
6. An error was made in figuring capital gains and losses on Schedule D.	111,453
7. An error was made on Line 45 in subtracting Itemized or Standard Deduction from Adjusted Gross Income.	73,772
8. An error was made in transferring the Adjusted Gross Income from Line 15c to Line 43.	72,417
9. The amount of Federal Income Tax withheld does not agree with Forms W-2 or other supporting information.	74,878
10. An error was made in figuring the Credit for the Elderly.	66,295
11. An error was made in figuring Excess FICA/RRTA.	56,578
Form 1040A	
1. An error was made in computing Excess FICA/RRTA.	229,941
2. An error was made in computing the Overpayment of Balance Due.	265,360
3. The amount of withholding does not agree with Forms W-2.	137,882
4. An error was made in subtracting Line 14 from Line 13c to arrive at Taxable Income.	111,880
5. An error was made in multiplying the number of exemptions by $750.	82,027

[1] Total 1040 returns filed 53,910,752.
Total 1040A returns filed 28,688,599.

CHANGES TO 1977 FORMS OR INSTRUCTIONS

Significant changes to the forms or instructions for 1977 that will eliminate math errors follow.

Form 1040

1. The form has been designed in sequential format so that the taxpayer will not have the potential to make errors in transferring numbers.
2. The return is being printed in two colors so that the lines that must be filled in by the taxpayer stand out.
3. Zero Bracket Amount (Standard Deduction) has been changed to a flat amount and is built into tax tables and tax rate schedules.
4. Tax tables have been expanded so that most taxpayers will not have to compute taxable income or general tax credit.

Form 1040A

1. The return is being printed in two colors so that the lines that must be filled in by the taxpayer stand out.
2. Better instructions have been provided to the taxpayers to utilize IRS to compute their returns by indicating on the return what items to fill in and where to stop.
3. Only taxpayers who have income and exemptions that are covered in the tax tables can file a Form 1040A.
4. All special computations have been eliminated (*i.e.,* students who can be claimed on parent's returns; nonresident alien spouses; etc).

CHARACTERISTICS OF 1973 INDIVIDUAL INCOME TAX RETURNS OBTAINED BY THE TCMP

The attached information was obtained from the fifth cycle of the individual-income-tax-returns-filed phase of the Taxpayer Compliance Measurement Program (TCMP). TCMP is the major long-range research program of the Internal Revenue Service, which is used to obtain an accurate measure of its workload as well as its major characteristics so that alternative applications of its limited resources to solve the enforcement problems of the federal tax system can be evaluated. Stratified probability sampling techniques are used in TCMP to keep program costs at a minimum. Cycle five of the individual-income-tax-filed phase of TCMP used a probability sample of approximately 51,000 returns to estimate characteristics of the more than 80 million 1973

individual returns filed in 1974. This is the most current TCMP information available with detailed data on individual tax returns filed.

Most of the line items with a high frequency of error fell into the itemized deduction category. Although it is not possible from the data to identify the specific cause of the error, the line items identified are:

1. Other Deductions Medical—This refers to all deductible medical expenses other than half the medical insurance premium.
2. Taxes other—This refers to all deductions for taxes other than real estate and state and local income.
3. Interest other—This refers to all deductions for interest other than home mortgage.
4. Contributions Cash—Excludes contributions other than cash.
5. Casualty or Theft Losses—After reimbursement and $100 deductible.
6. Expenses for child and dependent care services.
7. Other Deductions—Total miscellaneous deductions other than alimony, union dues, and child care.
8. Rents—The amount shown in Part II, Schedule E, Form 1040 applicable to rental income.
9. Moving expenses—The amount shown on line 40 of Form 1040 for 1973.
10. Employee Business Expense—The amount shown on line 41 Form 1040 for 1973.
11. Exemption—Children Different Address—children listed on line 6D of Form 1040A or 1040 if the return reflects that they lived in the taxpayer's home for less than 6 months.
12. Investment Credit—Amount shown on line 50 Form 1040 for 1973.

TCMP Phase III, Cycle 5 Estimated Frequency and Amount of Error on Individual Returns Filed for Tax Year 1973 for Line Items with High Frequency of Error

Line Item	(1) No. Reported (000)	(2) No. Changed (000)	(3) No. Not Rept. But Est. (000)	(4) % Change $\frac{(2)+(3)}{(1)+(3)}$	(5) Amt. Reported (In Million Dollars)	(6) Amt. Changed [1] (In Million Dollars)	(7) Amt. Not Rept. But Established (In Million Dollars)	(8) % Change $\frac{(6)+(7)}{(5)+(7)}$	(9) Avg. Amt. of Adj. Per Changed Ret. $\frac{(6)+(7)}{(2)+(3)}$
Income									
Rents	6,154	3,408	209	56.8%	$ 1,766	$2,360	$156	130.9%	$ 695
Adjustments									
Moving Expenses	1,219	616	129	55.3	1,362	198	67	18.6	356
Employee Business Expenses	5,154	2,769	494	57.8	7,062	1,894	337	30.2	684
Exemptions									
Children—Different Add.	986	328	259	47.2	1,325	442	319	46.3	1,297
Deductions									
Medical—Other than Ded. of one half Med. Insur. Premium	13,586	10,195	301	75.6	8,738	2,195	110	26.0	220
Taxes—Other than Real Estate and State and Local Income	27,830	14,746	414	53.7	11,289	1,724	94	16.0	120
Interest—Other than Home Mortgage	22,005	10,239	405	47.5	12,041	1,800	148	16.0	183
Contributions—Cash	25,987	10,465	426	41.2	11,765	1,818	104	16.2	176
Casualty, Theft Losses	1,956	1,243	47	64.4	1,263	573	13	45.9	454
Child Care [2]	1,777	1,041	34	59.4	1,268	522	7	41.5	492
Other Deductions	22,976	10,094	423	44.9	7,626	2,243	101	30.3	223
Credits									
Investment	2,842	923	1,213	52.7	1,047	182	155	28.0	$ 158

[1] Absolute value of all changes
[2] Changed to credit by Tax Reform Act of 1976

Source: Table TCMP Table 10

(Continued from inside front cover)

Charles H. Gustafson, an Associate Professor of Law at Georgetown University Law Center, received a B.S. degree from the University of Buffalo and a J.D. degree from the University of Chicago Law School. Mr. Gustafson was associated with several law firms in the private practice of law and had also served as attorney-adviser in the Office of the Legal Adviser, United States Department of State. He has been a consultant to the Privacy Protection Study Commission, the International Revenue Service Project of the Administrative Conference of the United States, and the Federal Home Loan Bank Board. Mr. Gustafson is a member of The American Law Institute and the American Bar Association.